
3000 SOURCE OF INCOME LAWS, TERMS, & CONCEPTS

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Reviewed: January 2004

3100 CALIFORNIA TAXATION

Residents

California taxes residents of California on their entire taxable income in accordance with CR&TC sec. 17041(a) and (c).

Example 1: Mary, a California resident, has the following income:

Wages earned in California	\$45,000
Wages earned in Japan	\$30,000
Interest from Nevada bank account	\$10,000
Total	<u>\$85,000</u>

Determination: Because Mary is a California resident, her total income of \$85,000 is taxable by California.

Nonresidents

CR&TC sec. 17951 provides that gross income of nonresidents includes only income from California sources. The word "source" pertains to the place of origin.

CR&TC sec. 17041(b) and (d) provide that nonresidents are taxed only on taxable income derived from sources within California.

Example 2: John, a nonresident of California, has the following income:

Wages earned in California	\$45,000
Wages earned in Japan	\$30,000
Interest from Nevada bank account	\$10,000
Total	<u>\$85,000</u>

Determination: Because John is a nonresident, only his California source wages of \$45,000 are taxable by California.

Part-Year Residents

California taxes part-year residents on taxable income derived from California sources during the period they were nonresidents under CR&TC sec. 17041(b) and (d) and their entire taxable income during the period which they were residents under CR&TC sec. 17303 and CR&TC sec. 17041(a) and (c).

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Example 3: Beth became a California resident on July 1, 2001. She earned the following income during 2001:

Florida wages from January 1, 2001 to June 30, 2001	\$50,000
California wages from January 1, 2001 to June 30, 2001	\$10,000
California wages from July 1, 2001 to December 31, 2001	\$30,000
Florida wages from July 1, 2001 to December 31, 2001	\$ 5,000
Total	<u>\$95,000</u>

Determination: California taxes the following income:

California wages from January 1, 2001 to June 30, 2001	\$10,000
California wages from July 1, 2001 to December 31, 2001	\$30,000
Florida wages from July 1, 2001 to December 31, 2001	\$ 5,000
Total	<u>\$45,000</u>

For taxable years beginning prior to January 1, 2002:

CR&TC sec. 17041(b) and (d) provide that nonresidents and part-year residents compute their tax liability by multiplying the amount of tax they would owe if they were residents for the entire year by the ratio of California adjusted gross income over total adjusted gross income.

Example 4: Taxable Year 2001

Tom lived in Washington until March 31, 2001. He became a California resident on April 1, 2001. Tom earned and received wages of \$15,000 in Washington while he was a Washington resident, and he earned wages of \$65,000 while he was a California resident. Tom also earned \$4,000 in interest income during the taxable year; \$1,000 while a resident of Washington and \$3,000 while a California resident.

Tom is single and had the following itemized deductions:

Real estate taxes:	\$ 1,200	(CA house)
	800	(WA house)
Mortgage interest:	17,000	(CA house)
	3,500	(WA house)
Charitable contributions:	<u>1,500</u>	(NY Firefighters' Fund)
	\$24,000	

Calculation of Tom's 2001 California Tax Liability:

CA AGI:	\$65,000	(CA wages)
	+ 3,000	(Interest earned while a CA resident)
	<u>\$68,000</u>	
Total AGI:	\$80,000	(Wages from all sources)
	+ 4,000	(Interest income from all sources)
	<u>\$84,000</u>	
Taxable Income:	\$84,000	(Total AGI)
	- 24,000	(Total itemized deductions)
	<u>\$60,000</u>	
Tax on Taxable Income:	\$ 3,733	(Tax table)
Minus Exemption Credits:	<u>\$ - 79</u>	
Net Tax:	\$ 3,654	
Ratio:	<u>\$68,000</u>	(CA AGI)
	\$84,000	(Total AGI)
Prorated Tax:	\$ 3,654	(Net tax)
	x .8095	(Ratio) (\$68,000/\$84,000)
Tax Liability:	<u>\$ 2,957</u>	

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For taxable years beginning on or after January 1, 2002:

CR&TC sec. 17041(b) and (d) are amended to provide that nonresidents and part-year residents compute their tax liability by multiplying their taxable income (defined below) by a rate equal to the amount of tax they would owe if they were residents of California for the taxable year and for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by the amount of that income.

The term "taxable income of a nonresident or part-year resident" as defined in CR&TC section 17041(i)(1) includes each of the following:

- (A) For any part of the taxable year during which the taxpayer was a California resident, all items of gross income and all deductions, regardless of source.
- (B) For any part of the taxable year during which the taxpayer was not a resident of California, gross income and deductions derived from sources within California.

CR&TC sec. 17303 is repealed for taxable years beginning on or after January 1, 2002.

CR&TC section 17015.5 was added to provide the term "part-year resident" to mean a taxpayer who meets both of the following conditions during the same taxable year:

- a) Is a resident of this state during a portion of the taxable year.
- b) Is a nonresident of this state during a portion of the taxable year.

For taxable years beginning in 2002, nonresidents and part-year residents, determine their California tax by multiplying their California taxable income by an effective tax rate. The effective tax rate is the California tax on all income as if the taxpayer were a California resident for the current tax year and for all prior tax years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by that income. Use the following formula:

$$\text{Prorated tax} = \text{California taxable income} \times \frac{\text{Tax on total taxable income}}{\text{Total taxable income}}$$

Key Definitions:

California taxable income: California adjusted gross income (AGI) less
 California itemized or standard deductions

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California AGI:	Gross income and deductions derived from California sources for any part of the taxable year during which a taxpayer was a nonresident <u>plus</u> all items of gross income and all deductions, regardless of source, for any part of the taxable year during which the taxpayer was a resident.
Total AGI:	The adjusted gross income from all sources for the entire taxable year.
California itemized or standard deductions:	Determined by applying the ratio of California AGI to total AGI to <u>all</u> itemized or standard deductions allowed to California residents.
Total taxable income:	The entire taxable income determined as if the taxpayer were a California resident for the current taxable year, <u>and</u> for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions.

Percentage Calculations:

Itemized or standard deductions:	Divide the California AGI by the total AGI (not to exceed 1.0):
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$$\frac{\text{California AGI}}{\text{Total AGI}}$$

Tax rate:	Divide the tax on total taxable income by the total taxable income:
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$$\frac{\text{Tax on total taxable income}}{\text{Total taxable income}}$$

Credits:	Divide the California taxable income by the total taxable income:
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$$\frac{\text{California taxable income}}{\text{Total taxable income}}$$

Note: This percentage does not apply to renter's credit, other state tax credit, or credits conditional upon a transaction occurring wholly within California.

California allows these credits in full.

The following example shows how the calculation works:

Example 5: Taxable Year 2002

John was a Florida resident until March 31, 2002. While a Florida resident, he earned and received wage income of \$15,000 and interest income of \$1,000. On April 1, 2002, John permanently moved to California. While a California resident, John earned and received wage income of \$65,000 and interest income of \$3,000. John was single and had the following itemized deductions in 2002:

Real estate taxes:	\$ 1,200	(California house)
	800	(Florida house)
Mortgage interest:	17,000	(California house)
	3,500	(Florida house)
Charitable contributions:	1,500	(New York Firefighters' Fund)
	<u> </u>	
	\$24,000	
	<u> </u>	

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Tax on total taxable income:	\$ 3,705	(Tax table)
Prorated tax:	\$48,572	(California taxable income)
	x .0618	<u>Tax on total taxable income</u>
		Total taxable income
	<u>\$ 3,002</u>	
Prorated exemption credit:	\$ 80	(Personal exemption credit)
	x .8095	<u>California taxable income</u>
		Total taxable income
	<u>\$ 65</u>	
Tax liability:	\$ 3,002	(Prorated tax)
	- 65	(Prorated exemption credit)
	<u><u>\$ 2,937</u></u>	

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3200 COMMUNITY INCOME

California Code of Regulations section 18501, formerly CCR sec. 18402, requires that if a married couple files separate returns, each spouse must report all income from his or her separate property and one-half of any community income. We divide community income equally between spouses. According to the regulation, the laws of the state where the earning spouse is domiciled determine whether or not income is considered community income. If the acquiring spouse is domiciled in a community property state we consider his or her income community income. If the acquiring spouse is domiciled in a separate property state, we consider his or her income separate income.

The *Appeal of Richard and Eva Taylor*, 1988-SBE-028, November 29, 1988, considers the allocation of income where the husband leaves this State but remains domiciled in California while absent for other than a temporary and transitory purpose. [FTB Publication 1031](#), *Guidelines for Determining Resident Status*, contains a chart illustrating how spouses filing separate returns should split their income.

Example 1: Mark and Lisa are married. Mark is domiciled in and a resident of California. Lisa is domiciled in California, but a resident of Michigan. Mark sometimes travels outside of California to perform his work. For 2001, Mark earned \$70,000 while working in California and \$30,000 while working in Iowa. He had no other income for 2001. Lisa earned no income during 2001.

Determination:

Step 1: Split income based on domicile.

Mark is domiciled in California, a community property state. Therefore, Mark's wage income must be split 50/50 with his spouse, Lisa.

Wages	Mark	Lisa
California, \$70,000	\$35,000	\$35,000
Iowa, \$30,000	\$15,000	\$15,000
Total:	<u>\$50,000</u>	<u>\$50,000</u>

Step 2: Apply California source of income law.

Mark is a California resident. Residents are taxed on income from **all** sources. Lisa is a nonresident of California. Nonresidents are taxed on income from **California** sources.

Income taxable

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	by California
Mark's 50% share of his wages:	\$50,000
Lisa's 50% share of Mark's wages earned in California:	\$35,000
Total	<u>\$85,000</u>

If a husband and wife are separated with no intention of resuming a marital relationship and choose to file separate returns, they must report all income separately.

The following states are community property states:

Arizona	Louisiana	Texas
California	Nevada	Washington
Idaho	New Mexico	Wisconsin

According to [IRS Publication 555](#), *Community Property*, income from most separate property is community income in Idaho, Louisiana, Texas, and Wisconsin. In the other community property states, income from separate property is not community income.

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3300 REAL OR TANGIBLE PERSONAL PROPERTY

According to California Code of Regulations section 17951-3, income derived from real or tangible personal property located in this state is California source income. This includes:

- Rents from real and tangible personal property located in California
- Gains realized from the sale or transfer of such property regardless of where the sale or transfer is consummated and
- Any other type of income derived from the ownership, control or management of real and tangible personal property located in California irrespective of whether a trade, business, or profession is carried on within California.

Example 1: Brian, a nonresident of California, owns a rental home located in California. His net income from the rental property is \$7,000.

Determination: The \$7,000 is taxable by California because the source of the rental income is California.

The *Appeal of L. N. and Mary C. Hagood*, 1960-SBE-026, November 14, 1960, held that oil and gas leases of lands located in California constitute real property and the income derived from the leases was California source income.

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3310 BUSINESS, TRADE, OR PROFESSION

California Code of Regulations section 17951-4(a) provides that the net income from a nonresident's business, trade, or profession carried on wholly within this state is California source income. Conversely, none of the net income from a nonresident's business, trade, or profession carried on entirely outside of this state is California source income.

CCR section 17951-4(b) provides that if a nonresident's business, trade, or profession is conducted within and without California, and the part within California is so separate and distinct from the part without California such that the respective business activities are not part of a unitary business, trade, or profession, only the net income from within California is included in California source income.

Example 1: Julie, an Oregon resident, operates a real estate business in California and an unrelated retail business in Oregon.

Determination: Julie includes only the net income from the real estate business as California source income.

If a sole proprietorship, partnership, S corporation, or limited liability company operates within and without California as a unitary business, trade or profession, we determine the amount of net income derived from sources within California in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act as contained in CR&TC sec. 25120 - CR&TC sec. 25139 and their related regulations [CCR sec. 17951-4(c), (d), (e) and (f)].

For taxable years beginning on or after January 1, 2001:

CCR sec. 17951-4(c), (d), (e), and (f) are amended to provide that we determine the source of net income which is not business income by using the sourcing rules of CR&TC sec. 17951 - CR&TC sec. 17955 and the related regulations. We no longer use the nonbusiness allocation rules of the Uniform Division of Income for Tax Purposes Act as contained in CR&TC section 25120 - CR&TC section 25139 and their related regulations [CCR section 17951-4(c), (d), (e) and (f)].

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3320 PARTNERSHIPS, S CORPORATIONS, AND CERTAIN TRUSTS

Nonresidents:

California taxes a nonresident's distributive share of partnership, S corporation, and trust income derived from California sources. Income from a simple trust (one which distributes its income annually) is subject to these rules. Income from other trusts may also be subject to these rules.

The nonresident partner's distributive share of partnership income apportioned to California is California source income. See the *Appeal of Lore Pick*, 1985-SBE-066, June 25, 1985, and the *Appeal of George D. Bittner*, 1985-SBE-111, October 9, 1985.

Example 1: Mary is a nonresident of California and holds a partnership interest in a California partnership. She received a Schedule K-1 from the California partnership that included net income of \$10,000 from California sources.

Determination: Mary's \$10,000 distributive share of partnership net income has a source in California and is taxable by California.

California Code of Regulations section 17951-4(d)(2) provides that we treat the source of guaranteed payments received by a nonresident partner as a distributive share of partnership income. See [FTB Notice 89-493](#).

Part-Year Residents:

- **For taxable years beginning prior to 2002:**

Partnerships:

As decided in the *Appeal of Jerald L. and Joan Katleman*, 1976-SBE-110, December 15, 1976, and the *Appeal of Dennis and Dianne Kimbrough*, 1984-SBE-105, June 27, 1984, a partner's distributive share of partnership income or loss accrues and is considered earned at the end of the partnership tax year. If the partner is a resident of California on the last day of the partnership's taxable year, the partner must report 100% of his or her distributive share of the net income or loss from the partnership regardless of where the partnership operated.

Example 2: Robert became a California resident on November 1, 2001. During the year, he was a partner in an Oklahoma partnership. The partnership year-end was December 31, 2001. Robert's distributive share of the partnership's net income for the year was \$12,000.

Determination: Since Robert was a California resident when the partnership year ended, Robert's entire distributive share of \$12,000 is taxable by California.

Under California Revenue and Taxation Code section 18535, nonresident partners of California partnerships and partnerships deriving income from California sources may elect to file a single group 540NR return. The highest marginal rate is used to compute the tax.

S corporations:

We determine the amount of the nonresident's pro rata share of S corporation income derived from sources within California in the same manner as if the S corporation were a partnership. See *Gene Valentino v. Franchise Tax Board*, 87 Cal. App. 4th 1284 (2001).

Example 3: Jennifer became a Nevada resident on June 27, 2001. During the year, she was a shareholder in a Wyoming S corporation. No income from the S corporation was derived from California sources. The S corporation's year-end was December 31, 2001. Jennifer's distributive share of the corporation's net income for the year was \$10,000.

Determination: Because Jennifer was a nonresident when the S corporation year ended and the income from the corporation was not from California sources, no income is taxable by California.

Example 4: Paul is a nonresident of California. During 2001, he was a shareholder in an S corporation based in California. 70% of his pro rata share of net income from the S corporation was derived from California sources. Paul's distributive share of the corporation's net income for the year was \$10,000.

Determination: Because 70% of the S corporation's net income is from California sources, Paul must include \$7,000 (\$10,000 x 70%) as income taxable by California.

The S corporation may file a single group 540NR return on behalf of its nonresident shareholders under CR&TC section 23810.

- **For taxable years beginning on or after January 1, 2002:**

If a taxpayer changes residency during 2002, or during the partnership's, S corporation's, or trust's taxable year ending on or after December 31, 2001, we tax the distributive share of partnership, S corporation, and trust income based upon the taxpayer's period of California residency and period of nonresidency during the partnership's or S corporation's taxable year. Income from a simple trust (one which distributes its income annually) is subject to these rules. Income from other trusts may also be subject to these rules.

The allocation of income between the period of residency and the period of nonresidency must be made in a manner that reflects the actual date of realization. In the absence of information that reflects the actual date of realization, the taxpayer must allocate an annual amount on a proportional basis between the two periods, using a daily pro rata method. See [Legal Ruling 2003-1](#) and [FTB Publication 1100](#).

Example 5: Harry holds a 50% S corporation interest in a Washington S corporation that reports income and losses on a fiscal year ending October 31st of each year. On June 10, 2002, he became a nonresident of California. Harry obtained interim statements from the S corporation that included the following S corporation net income amounts:

<u>November 1, 2001 - June 9, 2002</u>		<u>June 10, 2002 - October 31, 2002</u>	
Washington net income	\$ 5,600	Washington net income	\$ 4,400
California net income	<u>4,000</u>	California net income	<u>2,000</u>
Total net income	\$ 9,600	Total net income	\$ 6,400

Determination:

Step 1: Compute the distributive share income based upon periods of California residency and nonresidency during the S corporation's taxable year.

<u>Period of Residency</u>		<u>Period of Nonresidency</u>	
Total net income	\$9,600	California net income	\$ 2,000
% interest in S corporation	<u>X 50%</u>	% interest in S corporation	<u>X 50%</u>
2002 distributive share	<u>\$ 4,800</u>	2002 distributive share	<u>\$ 1,000</u>

Step 2: Compute the distributive share income to include in California taxable income.

Taxable year 2002:	<u>CA taxable income</u>
Distributive share, period of residency	<u>\$ 4,800</u>
Distributive share, period of nonresidency	<u>1,000</u>
Distributive share income, 2002	<u>\$ 5,800</u>

Example 6: Brian holds a 60% interest in a Washington partnership that reports income and losses on a calendar year basis. On September 22, 2002, he became a nonresident of California. Brian obtained a copy of the partnership tax return for 2002. The total net income from the

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partnership consisted of the following capital gains on items sold during Brian's periods of California residency and nonresidency:

<u>January 1, 2002 - September, 21, 2002</u>		<u>September 22, 2002 - December 31, 2002</u>	
Sale of WA real property	\$ 15,200	Sale of WA real property	\$ 4,400
Sale of stock	<u>2,000</u>	Sale of CA real property	<u>10,300</u>
Total net income	\$ 17,200	Total net income	\$ 14,700

Step 1: Compute the distributive share income based upon periods of California residency and nonresidency during the partnership's taxable year.

<u>Period of Residency</u>		<u>Period of Nonresidency</u>	
Total net income	\$17,200	California net income	\$ 10,300
% interest in partnership	X 60%	% interest in partnership	X 60%
2002 distributive share	<u>\$ 10,320</u>	2002 distributive share	<u>\$ 6,180</u>

Step 2: Compute the distributive share income to include in California taxable income.

Taxable year 2002:	CA taxable income
Distributive share, period of residency	<u>\$ 10,320</u>
Distributive share, period of nonresidency	<u>6,180</u>
Distributive share income, 2002	<u>\$ 16,500</u>

Example 7: Molly holds a partnership interest in a Texas partnership that reports its income and losses on a calendar year basis. On April 1, 2002, she became a nonresident of California. Molly received a Schedule K-1 from the Texas partnership that included net income of \$10,000, comprised of \$4,000 from California sources and \$6,000 from Texas sources.

Determination:

Step 1: Determine the number of California resident days and nonresident days during the partnership's taxable year.

<u>California Resident Days</u>	<u>California Nonresident Days</u>
January 1, 2002 through March 31, 2002 = 90 days	April 1, 2002 through December 31, 2002 = 275 days

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Step 2: Prorate the distributive share income based upon periods of California residency and nonresidency during the partnership's taxable year.

<u>Period of Residency</u>		<u>Period of Nonresidency</u>	
Distributive share income from all sources	\$10,000	Distributive share income from California sources	\$ 4,000
CA resident days ÷ total days 90 ÷ 365	X .2466	Nonresident days ÷ total days 275 ÷ 365	X .7534
Prorated 2002 distributive share	<u>\$ 2,466</u>	Prorated 2002 distributive share	<u>\$ 3,014</u>

Step 3: Compute the distributive share income to include in California taxable income.

Taxable year 2002:	CA taxable income
Distributive share, period of residency	<u>\$ 2,466</u>
Distributive share, period of nonresidency	<u>3,014</u>
Distributive share income, 2002	<u>\$ 5,480</u>

Example 8: Karen holds an S corporation interest in a Florida S corporation that reports income and losses on a fiscal year ending May 31st of each year. On February 1, 2002, she became a resident of California. Karen received a Schedule K-1 from the Florida S corporation for fiscal year ending May 31, 2002, that included net income of \$10,000, comprised of \$4,000 from California sources and \$6,000 from Florida sources.

Determination:

Step 1: Determine the number of California resident days and nonresident days during the S corporation's taxable year.

<u>California Resident Days</u>	<u>California Nonresident Days</u>
Feb. 1, 2002 through May 31, 2002 = 120 days	June 1, 2001 through Jan. 31, 2002 = 245 days

Step 2: Prorate the distributive share income based upon periods of California residency and nonresidency during the S corporation's taxable year.

<u>Period of Residency</u>	<u>Period of Nonresidency</u>
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Distributive share income from all sources	\$10,000	Distributive share income from California sources	\$ 4,000
CA resident days ÷ total days (120 ÷ 365)	X .3288	Nonresident days ÷ total days (245 ÷ 365)	X .6712
Prorated 2002 distributive share	<u>\$ 3,288</u>	Prorated 2002 distributive share	<u>\$ 2,685</u>

Step 3: Compute the distributive share income to include in California taxable income.

Taxable year 2002:

	CA taxable income
Distributive share, period of residency	\$ 3,288
Distributive share, period of nonresidency	2,685
Distributive share income, 2002	<u>\$ 5,973</u>

Example 9: Jane is the sole beneficiary of a simple trust that reported your distributive share income for the short period of January 1, 2002, through September 30, 2002. On April 1, 2002, she became a resident of California. Jane received a Schedule K-1 from the trust that included net income of \$10,000, comprised of \$4,000 from California sources and \$6,000 from Nevada sources.

Determination:

Step 1: Determine the number of California resident days and nonresident days during the trust's taxable year.

California Resident Days

April 1, 2002, through September 30, 2002
= 183 days

California Nonresident Days

January 1, 2002, through March 31, 2002
= 90 days

Step 2: Prorate the distributive share income based upon periods of California residency and nonresidency during the trust's taxable year.

Period of Residency

Distributive share income from all sources	\$10,000
CA resident days ÷ total days (183 ÷ 273)	X .6703

Period of Nonresidency

Distributive share income from California sources	\$ 4,000
Nonresident days ÷ total days (90 ÷ 273)	X .3297

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Prorated 2002 distributive share	<u>\$ 6,703</u>	Prorated 2002 distributive share	<u>\$ 1,319</u>
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Step 3: Compute the distributive share income to include in California taxable income.

Taxable year 2002:	CA taxable income
Distributive share, period of residency	<u>\$ 6,703</u>
Distributive share, period of nonresidency	<u>1,319</u>
Distributive share income, 2002	<u>\$ 8,022</u>

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3330 GAINS AND LOSSES FROM THE SALE OR TRADE OF BUSINESS PROPERTY

When a taxpayer sells property used in a trade or business or certain involuntary conversions (Internal Revenue Code section 1231 property), losses are netted against gains. If section 1231 losses exceed section 1231 gains, the losses receive ordinary tax treatment. If section 1231 gains exceed section 1231 losses, the gains receive capital gain tax treatment. Section 1231 gains and losses retain this characterization regardless of whether the taxpayer changes residency status.

For purposes of computing California taxable income, net only California source section 1231 gains and losses.

Example 1: Dan is a resident of Washington. In 2002, his California and non-California source section 1231 gains and losses included a \$3,000 California gain, a \$2,000 California loss, a \$4,000 Washington gain, and a \$5,000 Washington loss.

Determination: Based upon the netting of his total and California source section 1231 gains and losses, determine Dan's capital gain or ordinary loss as follows:

Taxable year 2002:	Total taxable income	CA taxable income
CA section 1231 gain	\$ 3,000	\$ 3,000
CA section 1231 loss	(2,000)	(2,000)
WA section 1231 gain	4,000	
WA section 1231 loss	(5,000)	
Capital gain	<u>\$ 0</u>	<u>\$ 1,000</u>

Example 2: Susan is a resident of Florida. In 2002, her California and non-California source section 1231 gains and losses included a \$2,500 California gain, a \$3,000 California loss, a \$1,000 Florida gain, and a \$500 Florida loss.

Determination: Based upon the netting of her total and California source section 1231 gains and losses, determine Susan's capital gain or ordinary loss as follows:

Taxable year 2002:	Total taxable income	CA taxable income
CA section 1231 gain	\$ 2,500	\$ 2,500
CA section 1231 loss	(3,000)	(3,000)
FL section 1231 gain	1,000	
FL section 1231 loss	(500)	
Ordinary loss	<u>\$ 0</u>	<u>\$ (500)</u>

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Reviewed: January 2004

3340 DEFERRED GAINS AND LOSSES (LIKE-KIND EXCHANGES)

When a taxpayer exchanges one kind of property for the same kind of property under the requirements of Internal Revenue Code section 1031, the taxpayer realizes a gain or loss on the transaction and defers paying tax on the gain or claiming the loss until the property is sold or otherwise disposed of. A gain or loss from the sale or exchange of real or tangible personal property located in California is sourced to California at the time the gain or loss is realized.

California Property Exchanged for Out-of-State Property:

If a nonresident exchanges real or tangible property located within California for real or tangible property located outside California, the realized gain or loss will be sourced to California. Taxation will not occur until the gain or loss is recognized. This requires the taxpayer to keep track of the deferred California sourced gains and losses to report them to California in the year the taxpayer sells or otherwise dispose of the property received in the exchange.

Example 1: As a resident of Texas, Jim exchanged a condominium located in California for like-kind property located in Texas. He realized a gain of \$15,000 on the exchange that was properly deferred under IRC section 1031. Jim then sold the Texas property in a non-deferred transaction and recognized a gain of \$20,000.

Determination: The \$15,000 deferred gain (the lesser of the deferred gain or the gain recognized at the time Jim disposed of the Texas property) has a source in California and is taxable by California.

Out-of-State Property Exchanged for California Property:

If a taxpayer exchanges real or tangible property located outside California for real or tangible property located within California, the gain recognized when the taxpayer sells or otherwise dispose of the California property in a non-deferred transaction has a California source and is taxable by California.

Example 2: As a resident of Nevada, Harry exchanged Nevada business property for like-kind California business property. He realized a \$10,000 gain on the exchange that was properly deferred under IRC section 1031. Harry then sold the California business property in a non-deferred transaction and recognized a gain of \$50,000.

Determination: Because the property is located in California, the \$50,000 gain has a California source and is taxable by California.

Example 3: While a resident of Kansas, Betty exchanged real property located in Kansas for like-kind real property located in California. She realized a \$12,000 gain on the exchange that was properly deferred under IRC section 1031. Betty then became a California resident and, while a resident, she sold the California property in a non-deferred transaction and recognized a gain of \$40,000.

Determination: California taxes the \$40,000 gain because Betty was a California resident at the time of the sale. If she paid tax to Kansas on the \$12,000 deferred gain, she is allowed a credit for taxes paid.

Reviewed: January 2004

3350 INTANGIBLE PERSONAL PROPERTY

California Revenue and Taxation Code section 17952 states that income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this state unless the property has acquired a business situs in California.

The California Supreme Court determined in Merton L. Miller v. Charles J. McColgan, (1941) 17 Cal. 2d 432, that gains from stock had their source in the stock itself and the situs of the stock was the residence of its owner. The court applied the doctrine of *mobilia sequuntur personam*, which means "movables follow the person".

Example 1: Beverly, a nonresident, owns stock in a California corporation from which she received \$7,000 in dividends.

Determination: Dividends have a source in the owner's state of residence. Therefore, the dividends Beverly received are not California source income.

Example 2: Stephanie moved from Nevada and became a California resident on May 1, 2001. However, she kept her money in a bank account in Nevada. From May 1, 2001 to December 31, 2001, the Nevada bank account earned \$900.

Determination: Interest income generally has a source in the recipient's state of residence. Because Stephanie became a California resident on May 1, 2001, the interest earned by Stephanie from May 1, 2001 to December 31, 2001, is considered California source income.

Example 3: During 2000 Ed was a part-year resident. He sold 500 shares of stock at a \$10,000 gain after becoming a California resident.

Determination: The gain on the sale of the stock is taxable by California because Ed was a California resident when he sold the stock.

A business situs is acquired in California if the property is employed as capital in California. A business situs is also acquired in California if the possession and control of the property has been localized in connection with a business, trade, or profession in California so that its substantial use and value attach to and become an asset of the business in this state. The entire income, including the gain from the sale of such an asset, is income from California sources. Examples are pledging an intangible asset as security for a loan in connection with a California business or maintaining a bank account for payment of expenses related to business activities in California. See California Code of Regulations section 17952.

CR&TC section 17955 provides that income of a nonresident from qualifying investment securities is not income from sources within this state if the taxpayer's only contact with this state is through a broker, dealer, or investment advisor located in this state.

Sale of a partnership interest is considered a sale of an intangible asset. See the *Appeal of Amyas and Evelyn P. Ames et al.*, 1987-SBE-042, June 17, 1987.

Reviewed: March 2005

3360 CAPITAL GAINS AND LOSSES

Always a Nonresident

If a taxpayer has always been a nonresident of California, the capital loss carryovers and capital loss limitations are based only upon California source income and loss items in order to compute California taxable income.

Example 1: Jill has always been a New York resident. In 2002, her California and non-California source capital gains and losses included California capital gains of \$2,000, California capital losses of \$6,000, New York capital gains of \$5,000, and New York capital losses of \$2,000. She had no capital loss carryovers prior to 2002.

Determination: Net Jill's capital gains and losses to determine the capital losses allowed in 2002 (the \$3,000 limitation applies) and the capital loss carryover to 2003.

Taxable year 2002:	Total taxable income	CA taxable income
CA capital gain	\$ 2,000	\$ 2,000
CA capital loss	(6,000)	(6,000)
NY capital gain	5,000	
NY capital loss	(2,000)	
Total	\$ (1,000)	\$(4,000)
Capital loss allowed in 2002	1,000	3,000
Capital loss carryover to 2003	\$ 0	\$(1,000)

Change of Residency to California (Move-In)

- **For taxable years beginning on or after January 1, 2002:**

If a taxpayer has capital loss carryovers and was a nonresident of California in prior years, the capital loss carryovers need to be restated as if the taxpayer had been a California resident for all prior years.

Example 2: Assume the same facts as Example 1. On January 1, 2003, Jill becomes a California resident. During 2003, she sells property located in Wyoming for a capital gain of \$5,000 and incurs a \$4,000 capital loss from the sale of property located in California.

Determination:

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Step 1: Restate Jill's 2002 capital loss carryover as if she had been a California resident for all prior years.

2002 Restatement:	Total taxable income
CA capital gain	\$ 2,000
CA capital loss	(6,000)
NY capital gain	5,000
NY capital loss	(2,000)
Total	\$ (1,000)
Capital loss allowed in 2002	1,000
Capital loss carryover to 2003	\$ 0

Step 2: Net Jill's capital gains and losses to determine the amount of capital gain income to include in total taxable income.

Taxable year 2003:	Total taxable income
CA capital loss	\$ (4,000)
WY capital gain	5,000
Capital loss carryover	0
Capital gain income	<u>\$1,000</u>

Change of Residency From California (Move-out)

- **For taxable years beginning in 2002:**

If a taxpayer has capital loss carryovers and becomes a nonresident of California, the capital loss carryovers need to be restated as if the taxpayer had been a nonresident of California for all prior years.

Example 3: Assume the same facts as Examples 1 and 2. On January 1, 2004, Jill becomes a nonresident of California again. During 2004, she sells property located in Texas for a capital gain of \$8,000, sells property located in California for a \$9,000 capital gain, and incurs a \$5,000 capital loss from the sale of property located in California.

Determination:

Step 1: Restate Jill's capital loss carryovers as if she had been a nonresident of California for all prior years by netting her capital gains and losses from California sources only.

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2002 Restatement:	Total taxable income	CA taxable income
CA capital gain	\$ 2,000	\$ 2,000
CA capital loss	(6,000)	(6,000)
NY capital gain	5,000	
NY capital loss	(2,000)	
Total	\$(1,000)	\$(4,000)
Capital loss allowed in 2002	1,000	3,000
Capital loss carryover to 2003	\$ 0	\$(1,000)

2003 Restatement:	Total taxable income	CA taxable income
CA capital loss, 2003	\$ (4,000)	\$ (4,000)
WY capital gain	5,000	
Capital loss carryover from 2002		(1,000)
Capital gain or loss	\$ 1,000	\$ (5,000)
Capital loss allowed in 2003		3,000
Capital loss carryover to 2004	\$ 0	\$(2,000)

Step 2: Net Jill's capital gains and losses to determine the amount of capital gain income to include in total taxable income and California taxable income.

Taxable year 2004:	Total taxable income	CA taxable income
CA capital gain	\$ 9,000	\$ 9,000
CA capital loss	(5,000)	(5,000)
TX capital gain	8,000	
Total	\$ 12,000	\$ 4,000
Capital loss carryover from 2003	0	(2,000)
Capital gain income	\$ 12,000	\$ 2,000

Part-Year Resident

- **Change of residency during taxable years beginning on or after January 1, 2002**

If a taxpayer changes residency during the year, compute income and deductions using resident rules for the period of the year the taxpayer was a California resident and nonresident rules for the period of the year the taxpayer was a nonresident. Compute any prior year carryover loss as if the taxpayer were a California resident for all prior years and as if the taxpayer were a nonresident

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for all prior years. Prorate both capital loss carryover amounts based upon the period of California residency and the period of nonresidency during the year.

Example 4: Peter became a California resident on July 1, 2002. His total and California source capital gains and losses for 2002 are as follows:

<u>Before July 1, 2002</u>		<u>After July 1, 2002</u>	
Total capital gains	\$ 10,000	Total capital gains	\$ 8,000
CA source capital gains	7,000	CA source capital gains	4,000
Total capital losses	(2,000)	Total capital losses	(3,000)
CA source capital losses	(1,000)	CA source capital losses	(3,000)

His capital loss carryover from 2001 was \$7,000, as if he had been a California resident for all prior years and \$5,000, as if he had been a nonresident for all prior years.

Determination:

Step 1: Net Peter's total capital gains and losses for the period of residency and his California source capital gains and losses for the period of nonresidency.

CA capital gains, before July 1, 2002	\$ 7,000
CA capital losses, before July 1, 2002	(1,000)
Total capital gains, after July 1, 2002	8,000
Total capital losses, after July 1, 2002	(3,000)
Capital gain before carryover losses	<u>\$ 11,000</u>

Step 2: Prorate Peter's capital loss carryover amounts based upon periods of California residency and nonresidency during 2002.

<u>Period of Residency</u>		<u>Period of Nonresidency</u>	
2001 carryover, as if a CA resident for all prior years	\$(7,000)	2001 carryover, as if a nonresident for all prior years	\$(5,000)
CA resident days ÷ total days (184 ÷ 365)	X .5041	Nonresident days ÷ total days (181 ÷ 365)	X .4959
Prorated 2001 capital loss	<u>\$(3,529)</u>	Prorated 2001 capital loss	<u>\$(2,479)</u>

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carryover

carryover

Step 3: Compute Peter's capital gain or loss to include in California taxable income.

Taxable year 2002:	CA taxable income
Capital gain before carryover losses	\$11,000
Capital loss carryover, resident period	(3,529)
Capital loss carryover, nonresident period	(2,479)
Capital gain, 2002	<u>\$ 4,992</u>

Reviewed: January 2004

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3400 COMPENSATION FOR PERSONAL SERVICES

Internal Revenue Code section 61(a)(1) defines gross income to include compensation for services, including fees, commissions, fringe benefits, and similar items. This section of the manual includes the following topics:

RSTM 3410	Taxpayer Becomes a California Resident (Move-In)
RSTM 3420	Taxpayer Becomes a Nonresident (Move-Out)/Taxpayer is a Nonresident for the Entire Year
RSTM 3430	Allocation of Compensation
RSTM 3440	Sick Leave, Vacation Pay, and Bonuses
RSTM 3450	Deferred Compensation Plans
RSTM 3460	Payments for Release from Contractual Obligations
RSTM 3470	Tax Equalization Payments
RSTM 3480	Moving Expenses

Reviewed: January 2004

3410 Taxpayer Becomes a California Resident (Move-In)

- **For taxable years beginning prior to January 1, 2002:**

To determine whether compensation is taxable by California when a taxpayer moves into California, two questions need to be answered in the affirmative:

1. Does California Revenue and Taxation section 17554 apply?
2. Did the income accrue?

1. Does CR&TC sec. 17554 apply?

CR&TC sec. 17554 provides that when a taxpayer changes from resident to nonresident (or vice versa) the accrual method of accounting is used to determine whether or not income is subject to California taxation.

In the *Appeal of Virgil M. and Jeanne P. Money*, 1983-SBE-267, December 13, 1983, the Board held that CR&TC sec. 17554 applies only when the following two conditions are met:

- (1) when California's sole basis for taxation is the taxpayer's residency, and
- (2) when that taxation would differ depending on whether the taxpayer used the accrual or the cash method of accounting.

CR&TC sec. 17554 applies to compensation (*Appeal of Virgil M. and Jeanne P. Money*, supra.).

2. Did the income accrue?

If CR&TC sec. 17554 applies, then it must be determined if the income accrued.

An amount is accrued when "all events" have occurred to fix the right to receive the income and the amount can be determined with reasonable accuracy. [Treas. Reg. §1.446 -1(c)(1)(ii) and *Spring City Foundry Co. v. Comm.*, [4 USTC 1276 (1934)].

Example 1: Bill lived and worked in Kentucky until April 30, 2000. He permanently moved to California on May 3, 2000. On May 7, 2000, Bill received his last monthly paycheck of \$3,000 in the mail from his Kentucky employer.

Determination: CR&TC sec. 17554 applies to Bill's compensation. Because all events have occurred to fix the right for Bill to receive his paycheck and the amount can be determined with reasonable accuracy prior to his move to California, the \$3,000 is not taxable by California.

- **For taxable years beginning on or after January 1, 2002:**

CR&TC sec. 17554, pertaining to income accrual, is repealed.

If a taxpayer is a California resident when compensation is received, the compensation is now taxable by California.

Example 2: Bill lived and worked in Kentucky until April 30, 2002. He permanently moved to California on May 3, 2002. On May 7, 2002, Bill received his last monthly paycheck of \$3,000 in the mail from his Kentucky employer.

Determination: The wage income of \$3,000 is taxable income because Bill was a California resident when he received the paycheck. If Bill also paid tax to Kentucky, he is allowed an Other State Tax Credit on this double-taxed income. See RSTM 3900.

Reviewed: January 2004

3420 Taxpayer becomes a Nonresident (Move-out)/ Taxpayer is a Nonresident for the Entire Year

In determining whether compensation is California source income after a taxpayer becomes a nonresident during the year or is a nonresident for the entire year, we tax on a source basis.

The critical factor in determining the source of income from personal services is not the residence of the taxpayer, the place where the contract for services is entered into, or the place of payment. It is the place where the services are actually performed. See the *Appeal of Janice Rule*, 1976-SBE-099, October 6, 1976; *Ingram v. Bowers*, 47 F. 2d 925, aff'd. 57 F. 2d 65; *Appeal of Charles W. and Mary D. Perelle*, 1958-SBE-057, December 16, 1958; and *Appeal of Robert C. and Marian Thomas*, 1955-SBE-006, April 20, 1955.

Example 1: Christine lives and works in Minnesota. She is temporarily assigned to California for three months to complete a project. She continues to receive her paycheck from the Minnesota headquarters of her employer. She earns \$5,000 a month.

Determination: The \$15,000 Christine earns while working in California is California source income and taxable by California.

Example 2: Steven lives and works in California. He is temporarily assigned to New York for five months to complete a project. He continues to receive his paycheck from the California headquarters of his employer. He earns \$5,000 a month.

Determination: The \$25,000 Steven earns while working in New York is not California source income. He did not perform the underlying services in California. However, because California residents are taxed on income from all sources, the \$25,000 Steven earns in New is taxable by California. If Steven also pays tax to New York, he is allowed an Other State Tax Credit on this double-taxed income. See RSTM 3900.

Example 3 - Jamie lived and worked exclusively in California until she retired on December 31, 2002. She moved to Nevada on January 1, 2003. Her former California employer pays its employees on the 5th of every month. On January 10, 2003, Jamie received in the mail her last paycheck of \$4,000 from her former California employer.

Determination: The \$4,000 of compensation is taxable by California because the income has a source in California, the state where Jamie performed her services.

Reviewed: January 2004

3430 Allocation of Compensation

When a part-year resident or a nonresident receives compensation for services performed within and outside California, we must determine the amount received for services performed in this state.

California Revenue and Taxation Code sec. 17954 provides that gross income from sources within and without California shall be allocated and apportioned under rules and regulations prescribed under our rules and regulations.

California Code of Regulations 17951-5 provides the following rules for allocating wages, salaries, and other compensation to determine the amount attributable to California sources:

<u>Category</u>	<u>Allocation Method</u>
Salesmen, agents, and other employees receiving commissions dependent upon volume of business. CCR section 17951-5(a)(1)	<u>Business transacted in CA</u> Business transacted everywhere
Employed in CA at intervals throughout the year and paid on a regular basis. CCR section 17951-5(b)	<u>Working days in CA</u> Working days everywhere
Employed in CA at intervals throughout the year and paid on a mileage basis. CCR section 17951-5(b)	<u>Miles in CA</u> Miles everywhere
Actors, singers, entertainers, etc. CCR section 17951-5(a)(2)	Gross amounts received for performances in CA
Attorneys, accountants, doctors, etc. CCR section 17951-5(a)(3)	Fees/ compensation received for services performed in CA
Employed continuously in CA for a definite portion of the year. CCR section 17951-5(a)(4)	Total compensation for period employed in CA
Employed in CA at intervals throughout the year and paid on some other basis. CCR section 17951-5(b)	Reasonable manner

The Board of Equalization and the courts have issued several decisions on apportioning compensation received for services performed within and without California. Typically, the decision focuses on determining the number of working days within and without California. See the [Appeal Of Estate Of Marilyn Monroe, Deceased](#), 1975-SBE-032, April 22, 1975, and the [Appeal of Sam and Betty Spiegel](#), 1986-SBE-121, June 10, 1986. In the [Appeal of Louis and Betzi Akerstrom](#), 1960-SBE-009, May 17, 1960, the Board used days in California divided by 365 because the taxpayer took very little vacation.

Many appeals have been heard on allocating professional athletes' income. In the [Appeal of Joseph Barry Carroll](#), 1987-SBE-026, April 7, 1987, the Board approved the use of the "duty days" method for professional athletes. "Duty days" generally include all working days from the beginning of official pre-season training through the last game in which the team competes. The California Court of Appeals (Court) affirmed this method in *Marc D. Wilson et al. v FTB*, 20 Cal. App. 4th 1441 (1993).

A decision related to allocating compensation received by a nonresident for services performed within and without California is *Paul L. and Joanne W. Newman v. FTB*, 208 Cal. App. 3d 972 (1989). The case focused on the salary received by the actor Paul Newman for filming the movie "The Sting." The Court determined that his salary should be allocated based on the ratio of duty-days in California over total duty-days. The Court included all filming and "on-call" days in the formula.

- **Airline Employees**

Pursuant to 49 U.S.C. section 40116(f)(2)(B), California does not tax the wages of a nonresident airline employee (i.e. pilot, copilot, flight attendant) unless more than 50% of the individual's scheduled flight time is in California.

If more than 50% of the scheduled flight time is in California, California allocates the wages as follows:

$$\text{Total wages} \times \frac{\text{Scheduled flight time in California}}{\text{Total scheduled flight time}} = \text{California source wages}$$

- **Railroad Employees and Truck Drivers**

Pursuant to 49 U.S.C. sections 11502(a) and 14503(a), the wages of nonresident railroad employees or truck drivers, who regularly perform their assigned duties in two or more states, are sourced to their state of residence.

- **Military Personnel**

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Pursuant to the Servicemembers Civil Relief Act (50 U.S.C. Appen. section 571), CR&TC section 17140.5 (c) provides:

- California does not tax the military compensation of a servicemember not domiciled in California.
- California may not use the military compensation of a servicemember not domiciled in California to increase the tax liability imposed on other income of military servicemembers or their spouses.

We tax all nonmilitary income from a California source regardless of whether or not a California domicile is established.

These special rules apply to military personnel only. They do not apply to civilian employees of the military.

Reviewed: March 2005

3440 Sick Leave, Vacation Pay, and Bonuses

- **For taxable years beginning prior to January 1, 2002:**

Sick leave and vacation pay earned by a nonresident for services performed in California are considered California source income. See the *Appeal of Edwin O. and Wanda L. Stevens*, 1986-SBE-100, May 6, 1986. Bonuses paid for services performed in California are also California source income.

A bonus received by a resident for services performed outside of California before becoming a resident is taxable by California if it is based on profits and the employer's taxable year ends after the taxpayer becomes a resident.

Some bonuses are contingent on the taxpayer being an employee on the date paid. In this situation, all the events to fix the right to receive the bonus would not occur until the date of payment.

- **For taxable years beginning on or after January 1, 2002:**

California Revenue and Taxation Code sec. 17554, pertaining to income accrual, is repealed.

If a taxpayer is a California resident when sick leave, vacation pay, and bonuses are received, the income is now taxable by California.

Example 1: Richard lived and worked in Maine until June 30, 2002, the date of his employer's taxable year-end. He permanently moved to California on July 5, 2002. On July 20, 2002, Richard received a bonus check of \$10,000 from his former Maine employer.

Determination: The bonus income of \$10,000 is taxable income because Richard was a California resident when he received the bonus check. If Richard also paid tax to Maine on this bonus, he is allowed an Other State Tax Credit. See RSTM 3900.

Reviewed: January 2004

3450 Deferred Compensation Plans

Nonqualified deferred compensation plans, such as performance incentive plans, long-term incentive plans and deferred bonus plans are considered compensation for services under the definition of Internal Revenue Code section 61(a)(1)/California Revenue and Taxation Code section 17071.

We do not distinguish between the portion of a payment from a deferred compensation plan deemed to be distributed from employer contributions and that deemed to be from the plan earnings. The fact that the earnings were accumulated and distributed does not change the nature of the income.

See RSTM 3410, RSTM 3420, and RSTM 3430 for determining the California taxation of compensation for services.

Reviewed: January 2004

3460 Payments for Release From Contractual Obligations

Payment for release from a contractual obligation to perform services in California is California source income. When a taxpayer is paid not to do something in California it stands in the same footing as if the taxpayer actually performed the services. See [Legal Ruling 133](#).

Reviewed: January 2004

3470 Tax Equalization Payments

- **For taxable years beginning prior to January 1, 2002:**

Many large companies that move employees overseas to work pay a tax equalization payment. The payment is to reimburse employees for the additional taxes they pay due to their overseas employment. Employees often receive the payments after arriving in California from a foreign assignment. The income is usually not taxable by California because the amount has accrued prior to the taxpayer becoming a California resident. However, when all the events to determine the amount with reasonable accuracy do not occur until after the taxpayer becomes a California resident, the payment has a California source. See the *Appeal of Carl M. and Sandra Paesel*, 1985-SBE-079, July 30, 1985.

For taxpayers who are residents throughout their overseas assignment, these payments are taxable by California.

- **For taxable years beginning on or after January 1, 2002:**

California Revenue and Taxation Code sec. 17554, pertaining to income accrual, is repealed.

If a taxpayer is a California resident when a tax equalization payment is received, the tax equalization payment is now taxable by California.

Example 1: Esther lived and worked in Germany until March 31, 2002. On August 1, 2002, Esther permanently moved to California and on August 15, 2002, she received her tax equalization payment from her former German employer.

Determination: The tax equalization payment is taxable by California because Esther was a California resident when she received the payment.

Reviewed: January 2004

3480 Moving Expenses

Reimbursement for moving expenses is included in California source income if the taxpayer is moving into California and the payment relates directly to the taxpayer's California employment. The payment represents compensation for services to be performed in this state. See the *Appeal of William H. Harmount and Estate of Dorothy E. Harmount, Deceased*, 1977-SBE-121, September 28, 1977, and *Appeal of Peter and Anita Berk*, 1984-SBE-101, June 27, 1984. We do not treat reimbursed out-bound moving expenses as California source income.

Reviewed: January 2004

3500 EMPLOYEE STOCK OPTIONS

RSTM 3510	Introduction
RSTM 3520	Nonstatutory Stock Options
RSTM 3530	Incentive Stock Options
RSTM 3540	Employee Stock Purchase Plans
RSTM 3550	California Qualified Stock Options
RSTM 3560	Stock Options Summary Table

Reviewed: March 2005

3510 Introduction

An employee stock option is the right or privilege granted by a corporation to purchase the corporation's stock at a specified price during a specified period.

Stock option plans that meet the requirements of IRC sec. 421 - IRC sec. 424 / CR&TC section 17501 and CR&TC section 17502 are referred to as *statutory* stock options; those that do not are referred to as *nonstatutory* (or nonqualified) stock options and are governed by IRC section 83 / CR&TC section 17081.

Statutory stock options consist of incentive stock options and employee stock purchase plans. Nonstatutory stock options are all other options. California law conforms to federal law concerning the taxation of statutory and nonstatutory stock options.

In addition to these stock options, CR&TC section 17502 provides for California qualified stock options.

This section of the manual provides information on the taxation of the various types of stock options and how to determine what stock option income is taxable by California when a taxpayer changes his or her residency status.

Key terms:

Grant date	The date the company grants the option to the employee
Option price	The price the employee will pay for the stock (also referred to as the grant price or exercise price)
Exercise date	The date the employee purchases the stock at the option price
Qualifying disposition	<p>A disposition that meets the following IRC section 422 or IRC section 423 holding period requirements:</p> <ul style="list-style-type: none"> • No sale of the stock within 2 years from the grant date of the option • No sale of the stock within 1 year after the date the taxpayer exercises the option

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Disqualifying disposition	A disposition that does not meet the holding period requirements of IRC section 422 or IRC section 423
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Reviewed: January 2004

3520 Nonstatutory Stock Options

Generally, a taxpayer recognizes taxable wage income upon the exercise of a nonstatutory stock option. The taxable wage income is the difference between the fair market value of the stock on the exercise date and the option price.

If a taxpayer pays taxes on this wage income to California and another state, the taxpayer may be allowed an Other State Tax Credit (OSTC) on this double-taxed income. See RSTM 3900.

California Resident on Exercise Date

If a taxpayer exercises a nonstatutory stock option while a California resident, California taxes the difference between the fair market value of the shares on the exercise date and the option price because the taxpayer is a California resident when the income is recognized. See the *Appeal of Earl R. and Alleene R. Barnett*, 1980-SBE-122, October 28, 1980.

Example 1: On March 1, 1997, while a resident of Michigan, Fred was granted nonstatutory stock options. On June 1, 2001, he retired and permanently moved to California. On August 1, 2001, Fred exercised his options.

Determination: Because Fred was a California resident when the nonstatutory stock option income is recognized; the difference between the fair market value of the shares on August 1, 2001, and the option price is wage income taxable by California. If Fred also paid tax to Michigan, he is allowed an OSTC against California taxes paid to Michigan on this double-taxed income.

Nonresident of California on Exercise Date

If a taxpayer exercises a nonstatutory stock option while a nonresident, the character of the stock option income recognized is compensation for services rendered. California taxes the income to the extent the taxpayer performed services in this state. See the *Appeal of Charles W. and Mary D. Perelle*, 1958-SBE-057, December 17, 1958.

All service performed within California:

If a taxpayer performs services for the corporation entirely within California but exercises the option after terminating employment and becoming a nonresident, the difference between the fair market value of the stock on the exercise date and the option price has a source in California, where the taxpayer performed the services.

Example 2: On February 1, 1998, while a resident of California, Joan was granted nonstatutory stock options. Joan performed all of her services in California from February 1, 1998, to May 1,

2001, the date she left the company and permanently moved to Texas. On June 1, 2001, Joan exercised her nonstatutory stock options.

Determination: The difference between the fair market value of the shares on June 1, 2001, and the option price is characterized as compensation for services having a source in California, the state where Joan performed all of her services.

Services performed within and outside California:

If a taxpayer performed services both within and without California, the taxpayer must allocate to California that portion of total compensation reasonably attributed to services performed in this state (California Code of Regulations section 17951-5).

One reasonable method is an allocation based on the time worked. The period of time the taxpayer performed services includes the total amount of time from the grant date to the exercise date (or the date the taxpayer's employment ended, if earlier).

The allocation ratio is:

$$\frac{\text{California workdays from grant date to exercise date}}{\text{Total workdays from grant date to exercise date}}$$

Income taxable by California = Total stock option income x Allocation ratio

Example 3: On November 1, 1997, while a resident of California, Betty was granted nonstatutory stock options. On November 1, 2001, she left the company and permanently moved to Florida. From November 1, 1997, through November 1, 2001, Betty worked for the company a total of 700 days in California and 300 days in other states. On December 1, 2001, she exercised her nonstatutory stock options.

Determination: The difference between the fair market value of Betty's shares on December 1, 2001, and the option price is stock option income characterized as compensation for services. The total number of workdays from grant date to exercise date equal 1,000 (700 California workdays + 300 other state workdays). The allocation ratio is .70 (700 California workdays ÷ 1,000 total workdays). Therefore, 70 percent of Betty's total stock option income is taxable by California.

Reviewed: March 2005

3530 Incentive Stock Options

Qualifying Disposition:

Internal Revenue Code section 422 provides for the tax deferral of income from the grant or exercise of an incentive stock option by an employee. Capital gain or loss is recognized when the stock is sold if the holding period requirements under IRC section 422 are met.

Disqualifying Disposition:

A disqualifying disposition results when the stock is sold before meeting the holding period requirements. The difference between the fair market value (or the sale price, if lower) of the stock on the exercise date and the option price is treated as ordinary income (wages). The increase between the stock's fair market value (FMV) on the sale date and the exercise date is a capital gain [Proposed Treas. Reg. 1.422A-1(b)(3)].

Incentive Stock Option Tax Treatment Summary Table

Disposition Type	Computation	Character
Qualifying disposition:	Sales price minus option price	Capital gain
Disqualifying disposition: Sales price > FMV on exercise date	FMV on exercise date minus option price	Ordinary income
	Sales price minus FMV on exercise date	Capital gain
Disqualifying disposition: Sales price < FMV on exercise date	Sales price minus option price	Ordinary income

If a taxpayer pays taxes on this wage income to California and another state, the taxpayer may be allowed an Other State Tax Credit on this double-taxed income. See RSTM 3900.

Alternative Minimum Tax:

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

For federal and California alternative minimum tax (AMT), stock acquired through the exercise of an incentive stock option must be treated as if the option were a nonstatutory stock option. This means that a taxpayer must generally include as an AMT adjustment, the difference between the fair market value of the stock on the exercise date and the option price in the year the option is exercised.

The AMT basis in the stock the taxpayer acquired from exercising the incentive stock option is increased by the amount of the adjustment. The taxpayer may be allowed an AMT credit in a subsequent year.

No AMT adjustment is required if the taxpayer disposes of the stock in the same year he or she exercised the option.

California Resident on Date of Stock Sale

Qualifying Disposition:

If a taxpayer exercises an incentive stock option while a nonresident of California and later sells the stock in a qualifying disposition at a gain while a California resident, the resulting capital gain is taxable by California because the taxpayer is a California resident when the stock is sold.

Example 1: On February 1, 1997, while a resident of Ohio, Peter was granted incentive stock options. On April 1, 2000, he exercised his options. On September 1, 2001, Peter permanently moved to California and sold his stock on October 15, 2001, for a gain.

Determination: Because Peter was a California resident when he sold the stock, the resulting capital gain is taxable by California.

Disqualifying Disposition:

If a taxpayer exercises an incentive stock option while a nonresident of California and later sells the stock in a disqualifying disposition while a California resident, the resulting wage income and capital gain (if applicable) are taxable by California because the taxpayer is a California resident when the stock is sold.

Example 2: On February 1, 1997, while a resident of Ohio, Sally was granted incentive stock options. On April 1, 2001, she exercised her options. On June 1, 2001, Sally permanently moved to California and sold her stock on October 1, 2001. The sale price is greater than the fair market value of the stock on the exercise date.

Determination: The resulting wage income and capital gain is taxable by California because Sally was a California resident on the date she sold the stock. If Sally also paid tax to Ohio on the wage income, she is allowed an Other State Tax Credit on this double-taxed income.

Nonresident of California on Date of Stock Sale

Qualifying Disposition:

If a taxpayer exercises an incentive stock option while a California resident or a nonresident and later sells the stock in a qualifying disposition while a nonresident, the income is characterized as income from the sale or disposition of intangible personal property having a source in the taxpayer's state of residence at the time the stock is sold. Accordingly, the taxpayer is not subject to regular tax by California even though the services that gave rise to the grant may have been performed in this state.

An AMT adjustment must be made in the year the taxpayer exercises the incentive stock option. The source of the adjustment is determined in the same manner as income from the exercise of nonstatutory stock options for regular tax purposes.

Example 3: On March 1, 1998, Mark was granted an incentive stock option. On March 1, 2000, he exercised his option. Mark was a California resident and performed all of his services in California from the grant date to the exercise date. On February 1, 2001, he permanently moved to Illinois. On June 1, 2001, he sold the stock at a gain.

Determination: Mark must make an AMT adjustment on his 2000 California return because he did not dispose of the stock in the year he exercised his option. The capital gain is not taxable by California in 2001 because Mark is a nonresident of California when he sold the stock.

Disqualifying Disposition:

If a taxpayer exercises an incentive stock option while a California resident or a nonresident and disposes of the stock in a disqualifying disposition while a nonresident, the transaction is treated as if the taxpayer exercised a nonstatutory stock option. The difference between the option price and the fair market value on the exercise date is wages. See *Sun Microsystems, Inc.*, 69 TCM 1884 (1995). The source of the income is where the taxpayer performed services between the grant date and the exercise date.

No AMT adjustment is required if the taxpayer disposes of the stock in the same year he or she exercises the option. However, if the stock is disposed of in a later year, then an AMT adjustment must be made in the year the taxpayer exercised the incentive stock option. The source of the

alterative minimum tax adjustment is determined in the same manner as is income from the exercise of a nonstatutory stock option for regular tax purposes.

Example 4: Harry was a resident of California and worked for X Company. He performed all of his services in California during his entire career. On April 1, 1998, Harry was granted an option to purchase stock under his company's incentive stock option plan. The option price on April 1, 1998, was \$10 per share. On April 1, 2000, while still living and working in California, Harry exercised his option to purchase 30,000 shares of his company's stock. The fair market value on April 1, 2000, was \$50 per share. On July 1, 2000, Harry retired and permanently moved to Florida. On October 15, 2000, he sold the 30,000 shares for \$35 per share.

Determination: The character of the income from the disqualifying disposition is wages. Because Harry performed all of his services in California between the grant date and the option exercise date, 100 percent of the income will be wages from a California source.

FMV of stock, date of sale:	\$ 1,050,000	(30,000 shares @ \$35* per share)
Less option price, date of grant:	- 300,000	(30,000 shares @ \$10 per share)
Wage income, CA source:	<u>\$ 750,000</u>	

*The sale price of \$35 is used to compute wage income because it is less than the exercise price of \$50. There was no increase in the share's fair market value from the exercise date to the sale date, thus there is no capital gain.

Harry does not need to make an AMT adjustment in tax year 2000 because he disposed of the stock in the same year he exercised his option.

Example 5: Assume the same facts as the previous example, except Harry sold the stock on March 15, 2001, when the fair market value of the stock was \$60 per share.

Determination:

Tax Year 2000

Harry must make an alterative minimum tax adjustment in tax year 2000 because he did not dispose of the stock in the same year he exercised his option. Because he performed 100 percent of his services in California, 100 percent of the AMT adjustment will have a California source. The adjustment is determined as follows:

FMV of stock, date of exercise:	\$ 1,500,000	(30,000 shares @ \$50 per share)
Less option price:	- 300,000	(30,000 shares @ \$10 per share)
AMT adjustment, CA source:	<u>\$ 1,200,000</u>	

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

Harry's AMT basis in the stock is determined as follows:

Option price:	\$ 300,000
Plus AMT adjustment:	<u>1,200,000</u>
AMT basis:	<u><u>\$ 1,500,000</u></u>

Tax Year 2001

Wage income from a California source is determined as follows:

FMV of stock, date of exercise:	\$ 1,500,000	(30,000 shares @ \$50 per share)
Less option price:	<u>- 300,000</u>	(30,000 shares @ \$10 per share)
Wage income, CA source income:	<u><u>\$ 1,200,000</u></u>	

The increase in the fair market value of the stock from the exercise price of \$50 to the sale price of \$60 is characterized as capital gain. The capital gain has a source in Florida, Harry's state of residence when he sold the stock.

FMV of stock, date of sale:	\$ 1,800,000	(30,000 shares @ \$60 per share)
Less FMV of stock, date of exercise:	<u>-1,500,000</u>	(30,000 shares @ \$50 per share)
Capital gain, FL source income:	<u><u>\$ 300,000</u></u>	

Harry may be allowed an AMT tax credit for prior year AMT.

Reviewed: March 2005

3540 Employee Stock Purchase Plans

Internal Revenue Code section 423 provides for the tax deferral of income from the grant or exercise of an option under an employee stock purchase plan. Income is recognized when the stock is sold.

If a taxpayer pays taxes to California and another state on any ordinary income recognized when the stock is sold, the taxpayer may be allowed an Other State Tax Credit on this double-taxed income. See RSTM 3900.

Qualifying Disposition:

A qualifying disposition occurs when the holding period requirements under IRC section 423 are met.

If the option is granted to the taxpayer at a discount and the taxpayer sells the stock in a transaction satisfying the holding period requirements, the gain is ordinary income (wages) up to the amount by which the stock's fair market value on the date the option was granted exceeded the option price. Any excess gain is capital gain. If there is a loss from the sale, it is a capital loss, and there is no ordinary income.

Disqualifying Disposition:

A disqualifying disposition results when the taxpayer sells the stock without meeting the holding period requirements. The ordinary income is the amount by which the stock's fair market value of the stock on the exercise date exceeded the option price. The basis in the stock is increased by the amount of this ordinary income. The difference between the increased basis and the selling price of the stock is a capital gain or loss.

California Resident on Date of Stock Sale***Qualifying or Disqualifying Disposition:***

If a taxpayer exercises an option under an employee stock purchase plan while a nonresident and later sells the stock in a qualifying or disqualifying disposition while a California resident, the resulting ordinary income and capital gain are taxable by California because the taxpayer is a California resident when the stock is sold.

Example 1: On March 1, 1998, while a resident of Massachusetts, Sam's employer granted him options at a discount under the company's stock purchase plan. On March 1, 2000, Sam

exercised his options. On December 1, 2000, Sam permanently moved to California and on April 1, 2001, he sold the options at a gain.

Determination: The resulting ordinary income and capital gain are taxable by California because Sam was a California resident when he sold the stock. If he also paid tax to Massachusetts, Sam is allowed an Other State Tax Credit against California taxes for taxes paid to Massachusetts on the double-taxed ordinary income.

Nonresident of California on Date of Stock Sale

Qualifying or Disqualifying Disposition:

If a taxpayer exercises an option under an employee stock purchase plan while a resident and later sell the stock in a qualifying or disqualifying disposition while a nonresident, the resulting ordinary income is taxable by California to the extent the taxpayer performed services in California from the grant date to the exercise date. Any capital gain has a source in the taxpayer's state of residence at the time the stock is sold.

Example 2: On February 1, 1998, Michelle's employer granted options to her under the company's employee stock purchase plan. On February 1, 2000, Michelle exercised these options. From the grant date to the exercise date, Michelle was a California resident and performed 50 percent of her services in California. On June 1, 2000, she permanently moves Nevada and on January 15, 2001, she sold the stock at a gain.

Determination: Because Michelle sold the stock before meeting the one-year holding period requirement; the difference between the fair market value of the stock on the date of exercise and the option price is taxable as wages. Since she performed 50 percent of her services in California from the grant date to the exercise date, 50 percent of the wage income is taxable by California. Any capital gain resulting from the increase in value over the fair market value on the date of exercise would have a source in Nevada, Michelle's state of residence when she sold the stock.

Reviewed: March 2005

3550 California Qualified Stock Options

CR&TC section 17502 provides that a stock option specifically designated as a California qualified stock option will receive the favorable tax treatment applicable to incentive stock options and employee stock purchase plans. In order to receive this treatment, the following conditions must be met:

1. The option is issued after January 1, 1997, and before January 1, 2002:
2. The earned income of the employee from the corporation granting the option for the taxable year in which that option is exercised does not exceed \$40,000.
3. The number of shares of stock granted under the option does not exceed 1,000, and the value of the shares does not exceed \$100,000.
4. The employee must be employed by the company at the time the option is granted or must have been employed within three months (one year if permanently disabled) of the date the option is granted.

If the provisions of CR&TC section 17502 are met, federal law treats a California qualified stock option as a nonstatutory stock option. For federal tax purposes, taxable wage income is recognized upon the exercise of a California qualified stock option. A taxpayer should make an adjustment to federal adjusted gross income on Schedule CA (540) or Schedule CA (540NR) for the California qualified stock option wage income included on the federal return.

In the year the stock is sold, any capital gain or loss differences should be reported on California Schedule D.

See RSTM 3530, Incentive Stock Options, to determine the California taxation of these options if there is a change in the taxpayer's residency.

If the provisions of CR&TC section 17502 are not met, the stock option is treated as a nonstatutory stock option. See RSTM 3520, Nonstatutory Stock Options, to determine the California taxation of these options if there is a change in the taxpayer's residency.

Reviewed: March 2005

3560 Stock Options Summary Table

Type of stock option	California residents	California nonresidents
Nonstatutory stock option (NSO)	on the date of NSO exercise: <ul style="list-style-type: none"> California taxes the wage income. Possible other state tax credit. 	on the date of NSO exercise NSO: <ul style="list-style-type: none"> California taxes the wage income to the extent services were performed in California from the grant date to the exercise date. Possible other state tax credit.
	on the date of stock sale: <ul style="list-style-type: none"> California taxes the capital gain. 	on the date of stock sale: <ul style="list-style-type: none"> California does not tax the capital gain.
Incentive stock option (ISO)	on the date of ISO exercise: <ul style="list-style-type: none"> If the stock is not sold in the year of exercise, make AMT adjustment. Increase AMT basis by the AMT adjustment. 	on the date of ISO exercise: <ul style="list-style-type: none"> If the stock is not sold in the year of exercise, make AMT adjustment. Include AMT adjustment to the extent services were performed in California from the grant date to the exercise date. Increase AMT basis by the AMT adjustment.
	on the date the stock is sold in a qualifying disposition at a gain: <ul style="list-style-type: none"> California taxes the capital gain. Possible AMT credit. 	on the date the stock is sold in a qualifying disposition at a gain: <ul style="list-style-type: none"> California does not tax the capital gain. Possible AMT credit.

	on the date the stock is sold in a disqualifying disposition: <ul style="list-style-type: none"> • California taxes the wage income and capital gain (if any). • Possible other state tax credit. • Possible AMT credit. 	on the date the stock is sold in a disqualifying disposition: <ul style="list-style-type: none"> • California taxes the wage income to the extent services were performed in California from the grant date to the exercise date. • California does not tax the capital gain (if any). • Possible other state tax credit. • Possible AMT Credit.
Employee stock purchase plans (ESPP)	on the date the stock is sold in a qualifying or disqualifying disposition at a gain: <ul style="list-style-type: none"> • California taxes the ordinary income and capital gain. • Possible other state tax credit. 	on the date the stock is sold in a qualifying or disqualifying disposition at a gain: <ul style="list-style-type: none"> • California taxes the ordinary income to the extent services were performed in California from the grant date to the exercise date. • California does not tax the capital gain (if any). • Possible other state tax credit.
California qualified stock options (CQSO)	and CR&TC section 17502 provisions are met: <ul style="list-style-type: none"> • Same tax treatment as ISO. 	and CR&TC section 17502 provisions are met: <ul style="list-style-type: none"> • Same tax treatment as ISO.
	and CR&TC section 17502 provisions are not met: <ul style="list-style-type: none"> • Same tax treatment as NSO. 	and CR&TC section 17502 provisions are not met: <ul style="list-style-type: none"> • Same tax treatment as NSO.

Reviewed: March 2005

3600 QUALIFIED PENSION, PROFIT SHARING, AND STOCK BONUS PLANS**Change of Residency to California (Move-in)**

- **For taxable years beginning prior to January 1, 2002:**

To determine whether qualified pension, profit sharing, and stock bonus plan income is taxable by California when a taxpayer moves into California, two questions need to be answered in the affirmative:

1. Does CR&TC sec. 17554 apply?
2. Did the income accrue?

1. Does CR&TC sec. 17554 apply?

CR&TC sec. 17554 provides that when a taxpayer changes from resident to nonresident (or vice versa) the accrual method of accounting is used to determine whether or not income is subject to California taxation.

CR&TC sec. 17554 does **not** apply to qualified pension, profit sharing, and stock bonus plans. See the *Appeal of Virgil M. and Jeanne P. Money*, 1983-SBE-267, December 13, 1983.

2. Did the income accrue?

Because CR&TC sec. 17554 does not apply, this question is irrelevant.

Example 1: Jim, a California resident, received qualified pension income during 1999 through a qualified plan from his former employer in Nevada. The pension relates to services he performed as an equipment operator in Nevada.

Determination: Because CR&TC sec. 17554 does not apply to Jim's qualified pension income, the pension income is taxable to California.

- **For taxable years beginning on or after January 1, 2002:**

CR&TC sec. 17554, pertaining to income accrual, is repealed.

If a taxpayer is a California resident when qualified pension, profit sharing, or stock bonus plan income is received, the income is taxable by California.

Example 2: Jim, a California resident, received pension income during 2002 through a qualified plan from his former Nevada employer. The pension relates to services he performed as an equipment operator in Nevada.

Determination: Jim's qualified pension income is taxable to California because he was a California resident when he received the income.

Change of Residency from California (Move-out)

CR&TC section 17952.5(a) states:

Gross income of a nonresident, as defined in 17015, from sources within this state shall **not** include "qualified retirement income" received on or after January 1, 1996, for any part of the taxable year during which the taxpayer was not a resident.

Refer to CR&TC section 17952.5(b) for the income included as "qualified retirement income".

Therefore, California can no longer tax the qualified retirement incomes received by nonresidents on or after January 1m 1996, even if the taxpayer performed the services that gave rise to the income in California.

Example 3: Laura is a nonresident of California. During 2001, she received qualified pension income, which she earned by performing services in California from 1990 through 1999.

Determination: Because Laura is a nonresident of California; the qualified pension income received in 2001 does not have a California source and is not taxable by California.

Reviewed: January 2004

3610 INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)

Nonresidents

California does not tax the IRA distributions of a nonresident.

Change of Residency to California (Move-in)

- **For taxable years beginning prior to January 1, 2002:**

A taxpayer received a stepped-up basis for annual contributions and earnings on them while the taxpayer was a nonresident when the contributions were made.

Example 1: Janet became a California resident on January 1, 2001. The fair market value of her IRA on January 1, 2001, was \$9,000. Janet received IRA distributions of \$1,500 in 2001.

Determination:

Taxable year 2001:

California IRA basis, January 1, 2001	\$9,000	(FMV on 1/1/01)
Less: IRA distribution	<u>1,500</u>	
California IRA basis, December 31, 2001	<u>\$7,500</u>	

- **For taxable years beginning on or after January 1, 2002:**

A taxpayer no longer receives a stepped-up basis for annual contributions and earnings on them simply because the taxpayer were a nonresident when the contributions were made.

Taxpayers are treated as though they were California residents for all prior years for all items of deferred income, which includes individual retirement accounts (IRAs). Accordingly, a taxpayer will be allowed a basis for contributions that were actually made, which would not have been allowed under California law had the taxpayer been a California resident.

California did not conform to the \$2,000 or 100% of compensation annual contribution limit permitted under federal law from 1982 through 1986. During these years, California limited the deduction to the lesser of 15% of compensation or \$1,500 and denied a deduction altogether to individuals who were active participants in qualified or government plans. Any amounts an individual contributed in excess of California deduction limits during these years create a basis in the IRA.

Example 2: Assume the same facts as Example 1. Janet's contributions in excess of California deduction limits during 1982-1986 were \$2,500. She received IRA distributions of \$3,000 in 2002.

Determination:

Taxable year 2002:

IRA distribution, 2002		\$3,000
Less:	California IRA basis	
	Contributions in excess of California deduction limits	\$2,500
Less:	California IRA basis recovered in 2001	<u>1,500</u>
	California IRA basis available in 2002	<u>1,000</u>
Taxable IRA income		<u><u>\$2,000</u></u>

Reviewed: January 2004

3700 INSTALLMENT SALES

Always a Nonresident

California taxes the installment proceeds received by a nonresident to the extent the income from the sale was from a California source. California taxes real property based upon where the property is located.

Example 1: Ken has always been a nonresident of California. On March 1, 2001, he sold a California rental property in an installment sale. During 2001 and 2002, he received installment proceeds comprised of capital gain income and interest income.

Determination: The capital gain income is taxable by California in both 2001 and 2002, because the property was located in California. The interest income is not taxable by California and has a source in Ken's state of residence.

Example 2: Lisa has always been a nonresident of California. On June 4, 2001, she sold a parcel of land located in Idaho on an installment basis. During 2001 and 2002, she received installment proceeds comprised of capital gain income and interest income.

Determination: Lisa's capital gain income is not taxable by California because the source of the gain is Idaho. The interest income is not taxable by California and has a source in Lisa's state of residence.

Change of Residency to California (Move-in)

- **For taxable years beginning prior to January 1, 2002:**

Installment proceeds received by a California resident from an out-of-state sale made before the taxpayer became a resident are not taxable by California. See California Code of Regulations sec.17554, Example 4. However, interest income received after becoming a California resident is taxable by California.

Example 3: Tim sold his Texas rental property on March 10, 1999 prior to becoming a California resident on May 1, 1999. The sale was made on the installment method. He received \$1,000 of interest on the installment note after becoming a California resident. His last installment payment was received on March 10, 2001.

Determination: None of the installment payments Tim received are subject to California tax since they were not derived from a California source and the right to receive them accrued before the change in Tim's residency status. The source of interest income is generally the taxpayer's state

of residence. Therefore, the interest income received after Tim became a California resident is taxable by California.

- **For taxable years beginning on or after January 1, 2002:**

California Revenue and Taxation Code sec. 17554, pertaining to income accrual, is repealed.

If a taxpayer is a California resident who sold property located outside California on the installment basis while a nonresident, the installment proceeds the taxpayer receives while a California resident are now taxable by California.

Example 4: On July 1, 2001, while a nonresident of California, Tim sold a Texas rental property in an installment sale. On May 15, 2002, he became a California resident and on August 1, 2002, he received installment proceeds comprised of capital gain income and interest income.

Determination: Tim's capital gain income and interest income received on August 1, 2002, are taxable by California because Tim was a California resident when he received the proceeds.

Example 5: On September 1, 2000, while a nonresident of California, Bob sold stock (intangible property) in an installment sale. On June 1, 2002, he became a California resident. On October 1, 2002, he received installment proceeds comprised of capital gain income and interest income.

Determination: Bob's capital gain income and interest income received on October 1, 2002, are taxable by California because he was a California resident when he received the proceeds.

Change of Residency from California (Move-out)

- **For taxable years beginning prior to January 1, 2002:**

Installment payments received by a nonresident from an out-of-state sale made while the taxpayer was a California resident are taxable by California. See CCR sec. 17554, Example 3. However, interest received after becoming a nonresident is not taxable by California.

Example 6: In January 1998, while a California resident, Steven sold a parcel of land located in Nevada on the installment basis. In December 2000, Steven became a resident of Texas. On January 2, 2001, Steven received installment proceeds comprised of capital gain income and interest income.

Determination: The capital gain portion of the installment proceeds received in 2001 is taxable by California because the installment sale accrued when Steven was a California resident. The

interest income has a source in Texas, Steven's state of residence when he received the proceeds.

- **For taxable years beginning on or after January 1, 2002:**

CR&TC sec. 17554, pertaining to income accrual, is repealed.

If a taxpayer is a former California resident, the installment proceeds received from the sale of property located outside California that the taxpayer sold while a California resident are no longer taxable by California.

Example 7: In June 1999, while a California resident, Beth sold a parcel of real property located in Washington in an installment sale. On March 1, 2002, she became an Ohio resident. On June 1, 2002, she received installment proceeds comprised of capital gain income and interest income.

Determination: The capital gain income is not taxable by California because the property was not located in California. The interest income is not taxable by California because Beth was a nonresident of California when she received the proceeds.

Example 8: In March 2000, while a California resident, Rick sold a parcel of real property located in California in an installment sale. On June 1, 2002, he became a Washington resident. On August 1, 2002, he received installment proceeds comprised of capital gain income and interest income.

Determination: The capital gain income is taxable by California because the property Rick sold was located in California. The interest income is not taxable by California because Rick was a nonresident of California when he received the proceeds.

Example 9: In September 1999, while a California resident, Alan sold stock (intangible property) in an installment sale. On February 1, 2002, he became a Florida resident, and on May 1, 2002, he received installment proceeds comprised of capital gain income and interest income.

Determination: The capital gain income from the sale of the stock is taxable by California because Alan was a California resident when he sold the stock. The interest income is not taxable by California because Alan was a nonresident of California when he received the proceeds.

Reviewed: January 2004

3710 ESTATES AND TRUSTS

CR&TC section 17953 states that income of estates and trusts distributed or distributable to nonresident beneficiaries is income from California sources only if the income of the estate or trust is derived from California sources. The determination of whether or not income generated from a California estate or trust is taxable to a nonresident is to be made in the same manner as it would be for the decedent or grantor. See the *Appeal of Estate of Marilyn Monroe, Deceased*, 1975-SBE-032, April 22, 1975.

CR&TC section 17953 also provides that nonresident beneficiaries shall be deemed to be the owner of intangible property owned by the estate or trust. Therefore, under the mobilia doctrine, the income from such property is excluded from California source income unless the property acquires a business situs California.

Reviewed: January 2004

3720 TAX TREATIES WITH FOREIGN COUNTRIES

United States tax treaties with foreign countries generally have no application to California tax determination. Income that is excluded for federal tax purposes under a federal tax treaty is not excluded for California income tax purposes. Most federal tax treaties specifically exclude application to state income taxes. However, if the treaty specifically states that it includes application to California taxes, we must follow the terms of the treaty. See Audit Program Report 84-8, 9/18/84.

Reviewed: January 2004

3730 COVENANT NOT TO COMPETE

CR&TC section 17954 authorizes us to prescribe rules and regulations for allocating and apportioning income from sources within and without California.

California Code of Regulations section 17951-6, Income from a Covenant Not to Compete, became operative as of 1/23/02 and is applicable to all open taxable years.

A covenant not to compete includes any arrangement to refrain from engaging in an activity, directly or indirectly, similar to the business activity carried on by the business that was sold. This definition includes, but is not limited to, covenants not to create or acquire an interest in a competitor, covenants not to solicit employees, and covenants not to disclose proprietary information [CCR section 17951-6(a)(4)].

The sale of a business includes all of the following [CCR section 17951-6(a)(5)]:

The sale or disposition of the goodwill of a sole proprietorship, partnership, limited liability company, S corporation, or C corporation.

- A. The sale or disposition of substantially all of the assets, together with the goodwill, of a sole proprietorship, partnership, limited liability company, S corporation, or C corporation.
- B. The sale or disposition of substantially all of an individual's interest in a sole proprietorship, partnership, limited liability company, S corporation, or C corporation, including but not limited to:
 - 1. The sale or disposition by a shareholder of substantially all of its shares in the corporation.
 - 2. The sale or disposition by a partner of substantially all of its interest in a partnership.

Payments received for a covenant not to compete are taxable as ordinary income. See *John D. Beals v. Commissioner*, 36-1 USTC 9917 (1936).

CCR section 17951-6(a) provides that income from a covenant not to compete executed in connection with the sale of a business conducted entirely within or both within and without California has a source in California to the extent the income is assigned to California by this regulation.

Identifying The Legally Enforceable Area:

Income from a covenant not to compete is assigned to California by first identifying the legally enforceable area within which the promisor forfeits the right to act [CCR section 17951-6(a)(1)].

Business and Professions Code sections 16600 and 16601 recognize that covenants not to compete are valid only if they are executed in connection with the sale of a business or its goodwill and only to areas where business was carried on. Courts interpreting Business and Professions Code section 16601 have limited the area of prohibition to places where business was carried on in substantial amounts. See *Kaplan v. Nalpak Corporation*, 158 Cal. App. 2d 197 (1958). Courts seem unwilling to void covenants not to compete. However, courts reform covenants that are overly broad in geographic scope to comply with the limits imposed by law. See *Swenson v. File*, 3 Cal. App. 3d 389 (1970).

A contract of sale containing a covenant not to compete that includes more territory than allowed by law or fails to limit the territory at all, is valid only within the area wherein the business is located. See [Legal Ruling 084](#), the *Appeal of James B. and Linda Pesiri*, 1989-SBE-027, September 26, 1989; and the *Appeal of AlDean and Clara Washburn*, 1982-SBE-140, June 29, 1982.

Note: If the covenant not to compete agreement is not governed under California law, we must review the enforceability of the agreement in its governing state.

Income Assignment:

After identifying the legally enforceable area of abstinence, we then assign the income to locations within this area according to the average of the apportionment factors (property, payroll, and sales) of the business in accordance with CR&TC section 25128(a). [CCR section 17951-6(a)(1)].

For taxable years of sale occurring on or after January 1, 1993, CR&TC section 25128(a) allows for a double-weighted sales factor and a denominator of four (four-factor formula). Prior to January 1, 1993, we weighted property, payroll, and sales equally (three-factor formula).

We must use the apportionment factors of the business that was sold for the year in which the sale occurred in all but unusual circumstances [CCR section 17951-6(a)(6)].

The factors are computed as follows:

Property Factor:

Property included in the denominator which is assigned to California

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Property assigned to the legally enforceable area

Payroll Factor:

Payroll included in the denominator which is assigned to California
Payroll assigned to the legally enforceable area

Sales Factor:

Sales included in the denominator which is assigned to California
Sales assigned to the legally enforceable area

For purposes of computing the sales factor, assign all sales of tangible personal property to the state of the purchaser where the property is delivered or shipped. The provisions of CR&TC section 25135(b), relating to throwback sales, shall not apply [CCR section 17951-6(a)(3)].

Public Law (PL) 86-272 forbids states from imposing an income tax on income derived within a state from interstate commerce if the only business activity within the state is the "solicitation of orders" for sales of tangible personal property. The orders must be sent out of the state for approval or rejection and, if approved, must be filled by shipment or delivery from a point outside the state. If sales are immune from taxation in a state by reason of PL 86-272, they are subject to throwback provisions.

You should assign any throwback sales included in the California sales factor to the state of destination only if that state is included in the legally enforceable area of abstinence. Such area includes only those in which the corporation conducted business in substantial amounts. (*Kaplan v. Nalpak*, supra.) If throwback sales were made to states where the corporation did not conduct sufficient activity to include that state in the enforceable area of abstinence, the throwback sales must reduce both the numerator and denominator of the California sales factor, and not simply reduce the California percentage.

Exception to the use of apportionment factors of the business for the year of sale:

If using the apportionment factors of the business for the year of sale does not fairly reflect the nature of prohibited activities expressed or reasonably implied by the covenant not to compete, or does not accurately represent the location of recent historical business activities of the business sold, such that there is a gross distortion of income assigned within the legally enforceable area, the Franchise Tax Board may require, or the promisor may petition the Franchise Tax Board for [CCR section 17951-6(a)(6)]:

- (a) The use of factors of the business which was sold for another year or combination of years; or
- (b) The employment of another method of assigned income; provided the

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use of another year or another method produces a fair and equitable assignment of income within the legally enforceable area.

Reviewed: January 2004

3740 ROYALTIES AND RESIDUALS

Generally, there are two types of royalties and residuals:

- Income received for the performance of personal services and
- Income received from the sale of rights to an independently developed finished product.

The landmark case for treating royalties as compensation for personal services having a source where the services were performed is *Ingram v. Bowers* 47F (2d) 925 D.C.S.D.N.Y. 1931, aff'd 57 F (2d) 65 CCA 2nd 1932. The issue involved in the case was whether the federal government had a right to tax income received as royalties by Enrico Caruso. Mr. Caruso, a famous Italian opera singer, was a nonresident alien. The royalties were received for records that were recorded in the U.S. and sold throughout the world. The courts held that Mr. Caruso had no right or interest in the records since they were the property of the recording company. The royalties he received were for performing services (i.e., recording records) in the U.S.

Do not confuse this type of income with true royalties such as those received by the author of a book or inventor of an invention for which he or she has a copyright or patent. Copyrights and patents are considered intangible assets. In such cases, the situs would generally be the state of residence of the author or inventor. See RSTM 3350 for more information concerning intangible assets.

The type of payment involved in the Caruso case was not related to a patent or copyright but was merely a payment for personal services measured by a percentage of future sales. The same rationale applies to motion picture and television residuals. The *Appeal of Estate of Marilyn Monroe, Deceased*, 1975-SBE-032, April 22, 1975, provided that California can continue to tax California source income after the death of the person who originally rendered the personal services.

Reviewed: January 2004

3800 ALIMONY

Residents:

Alimony received by a resident, whether paid by a nonresident or resident, is taxable. Alimony paid by a resident, even if paid to a nonresident, is deductible.

Nonresidents:

Alimony received by a nonresident is not taxable by California. See *Francis v. McColgan*, Cal. Crt. of App., (1951).

- **For taxable years beginning prior to January 1, 2004:**

Alimony paid by a nonresident, even if paid to a nonresident, is not deductible. See CR&TC section 17302, effective before February 11, 2004, and the [Appeal of William M. and Shirley D. Langston](#), 1983-SBE-010, January 3, 1983.

- **For taxable years beginning on or after January 1, 2004:**

Alimony paid by a nonresident is allowed in the same ratio (not to exceed 1.00) that California adjusted gross income, computed without regard to the alimony deduction, bears to total adjusted gross income, computed without regard to the alimony deduction. See CR&TC section 17302, effective February 11, 2004.

Example 1: Jeffrey, a Wyoming resident, paid \$12,000 in alimony during 2004. He owns rental properties in California and reports rental income of \$24,000 as his only California source income on Form 540NR. Jeffrey's total adjusted gross income (without regard to the alimony deduction) is \$240,000.

Determination: Jeffrey computes his alimony deduction as follows:

Alimony paid:			\$12,000
	<u>California AGI*</u>	<u>\$ 24,000</u>	
	Total AGI*	\$240,000	X 10%
Alimony deduction:			<u>\$ 1,200</u>

* Without regard to the alimony deduction

Part-Year Residents:

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California taxes alimony received during the period of residency. California does not tax alimony received during the period of nonresidency.

- **For taxable years beginning prior to January 1, 2004:**

Alimony paid during the period of residency is deductible and alimony paid during the period of nonresidency is **not** deductible.

- **For taxable years beginning on or after January 1, 2004:**

Alimony paid during the period of residency is deductible. Alimony paid during the period of nonresidency is allowed in the same ratio (not to exceed 1.00) that California adjusted gross income, computed without regard to the alimony deduction, bears to total adjusted gross income, computed without regard to the alimony deduction.

Example 2: During 2004, Helen, a part-year resident, made alimony payments totaling \$8,400 while she lived in California and alimony payments totaling \$6,000 after she permanently moved to New York. Helen's California AGI (without regard to the alimony deduction) is \$100,000 and her total AGI (without regard to the alimony deduction) is \$400,000.

Determination: Helen computes her alimony deduction as follows:

Alimony paid during residency period				\$8,400
Alimony paid during nonresidency period			\$6,000	
	<u>California AGI*</u>	<u>\$100,000</u>		
	Total AGI*	\$400,000	<u>X 25%</u>	
Alimony deduction allowed for nonresidency period				<u>1,500</u>
Total alimony deduction				<u>\$9,900</u>

* Without regard to the alimony deduction

Reviewed: March 2005

3810 DEDUCTIONS

California Revenue and Taxation Code section 17301 requires that we apportion and allocate deductions related to income from sources within and without California under our rules and regulations.

The federal foreign income exclusion, foreign tax deduction, and foreign earned income credit are not applicable to California.

Itemized Or Standard Deductions - Nonresidents And Part-Year Residents

- **For taxable years beginning prior to January 1, 2002:**

Subtract itemized or standard deductions allowed by California law from total adjusted gross income to determine taxable income. Compute the tax on taxable income and then apply it California using the ratio of California adjusted gross income to total adjusted gross income.

- **For taxable years beginning on or after January 1, 2002:**

Compute itemized or standard deductions allowed by California by applying the ratio of California adjusted gross income to total adjusted gross income to all itemized or standard deductions allowed to California residents.

Reviewed: January 2004

3820 NET OPERATING LOSSES

We allow a net operating loss (NOL) deduction under CR&TC section 17201 and CR&TC section 17276, which conform to Internal Revenue Code section 172.

- **For taxable years beginning prior to January 1, 2002:**

CR&TC sec. 17041(i)(2) limits the net operating loss deduction available to nonresidents and part-year residents to the sum of the portion attributable to the period in which the taxpayer was a California resident and the portion attributable to California source income. A taxpayer is not allowed a net operating loss deduction for California source purposes if he or she does not have a net operating loss from all sources. See the *Appeal of Harminder S. and Harpal Chana*, 1995-SBE-008, August 31, 1995.

Example 1: David is a resident of Nevada and operates two businesses. One business is conducted wholly within California and the other business is conducted wholly within Nevada.

In 2001 David's businesses produced the following results:

Taxable year 2001	<u>Income/loss all sources</u>	<u>CA source income/loss</u>
NV business	\$ 7,000	
CA business	(2,000)	\$ (2000)
Total	<u>\$ 5,000</u>	<u>\$ (2000)</u>

Determination: David's NOL deduction is limited by the amount of his NOL from all sources. Because he did not have an NOL from all sources, David is not allowed an NOL deduction for California tax purposes.

- **For taxable years beginning on or after January 1, 2002:**

A taxpayer can take a California net operating loss deduction for California source purposes without having to have a net operating loss from all sources.

CR&TC section 17041(i)(2) is amended to provide that for purposes of computing "taxable income of a nonresident or part-year resident", the amount of any net operating loss sustained in any taxable year during any part of which the taxpayer was not a resident of this state shall be limited to the sum of the following:

- (A) The amount of the loss attributable to the part of the taxable year in which the taxpayer was a resident.

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- (B) The amount of the loss which, during the part of the taxable year the taxpayer is not a resident is attributable to California source income and deduction allowable in arriving at taxable income of a nonresident or part-year resident.

Note: The NOL deduction for net operating loss carryovers is suspended for the 2002 and 2003 taxable years.

Always a Nonresident

For taxable years beginning in 2002, a taxpayer is allowed a net operating loss deduction carryover to 2004 for California taxable income based upon California sourced income and deductions, regardless of whether the taxpayer has an NOL in computing total taxable income.

Example 2: Assume the same facts as Example 1. In 2002, David's businesses produced the following results:

Taxable year 2002	Total taxable income	CA taxable income
NV business	\$ 9,000	
CA business	(3,000)	\$ (3,000)
Total	<u>\$ 6,000</u>	<u>\$ (3,000)</u>

Determination: Consider only David's California sourced income and losses when determining if he has a California NOL. For 2002, David's has a California NOL of \$3,000. He may carry forward \$1,800 (60% of the \$3,000 NOL), to 2004 to offset California taxable income.

Change of Residency to California (Move-in)

For taxable years beginning in 2002, if a taxpayer has NOL carryovers and was a nonresident of California in prior years, the NOL carryovers need to be restated as if the taxpayer had been a California resident for all prior years.

Example 3: Greta moved to California on January 1, 2002. In 2001, she operated a business located in Texas and incurred an NOL carryover based on California law of \$6,000 from this business. In 2002, Greta incurred a \$3,000 loss from her California business and she earned income of \$1,000 from her Texas business.

Determination:

Step 1: Restate Greta's 2001 NOL carryover as if she had been a California resident for 2001.

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2001 Restatement:

NOL carryover	\$ (6,000)
CA NOL allowed percentage, 2001	x 55%
NOL carryover to 2002	<u>\$ (3,300)</u>

Step 2: Net Greta's 2002 business income and losses to determine the amount of her NOL to carry forward to 2004.

Taxable year 2002:	Total taxable income
TX business income	\$ 1,000
CA business loss	(3,000)
Total	\$ (2,000)
CA NOL allowed percentage, 2002	x 60%
NOL, 2002	\$ (1,200)
Prior year NOL carryover	(3,300)
NOL carryover to 2004	<u>\$ (4,500)</u>

Change of Residency from California (Move-out)

For taxable years beginning in 2002, if a taxpayer has NOL carryovers and becomes a nonresident of California, the taxpayer's NOL carryovers need to be restated as if the taxpayer had been a nonresident of California for all prior years.

Example 4: Assume the same facts as Example 3. Greta's Texas and California businesses earned income in 2003. On January 1, 2004, Greta becomes a nonresident of California. In 2004, Greta's Texas and California businesses earn income of \$5,000 and \$4,000, respectively.

Step 1: Restate Greta's NOL carryovers as if she had been a nonresident of California for all prior years by netting business income and losses from California sources only.

2001 Restatement:	Total taxable income	CA taxable income
Texas source business loss	\$(6,000)	
CA NOL allowed percentage, 2001	x 55%	
NOL carryover to 2002	<u>\$(3,300)</u>	<u>\$ 0</u>
2002 Restatement:	Total taxable income	CA taxable income

TX business income	\$ 1,000	
CA business loss	(3,000)	\$ (3,000)
Total	\$ (2,000)	\$ (3,000)
CA NOL allowed percentage, 2002	x 60%	x 60%
NOL, 2002	\$ (1,200)	\$ (1,800)
Prior year NOL carryover	(3,300)	
NOL carryover to 2004	\$ (4,500)	\$ (1,800)

Part-Year Resident

If a taxpayer changed residency during 2004, compute the NOL deduction using resident rules for the period of the year the taxpayer was a California resident and nonresident rules for the period of the year the taxpayer was a nonresident. Compute any NOL carryovers as if the taxpayer were a California resident for all prior years **and** as if the taxpayer were a nonresident for all prior years. Prorate both NOL carryover amounts based upon the period of California residency and the period of nonresidency during the year.

Example 34 - Henry moved to California on May 1, 2004. His total and California source income and losses from his business operations for 2004 were as follows:

<u>Before May 1, 2004</u>		<u>After May 1, 2004</u>	
Total business income	\$ 12,000	Total business losses	\$ (16,000)
CA business losses	(2,000)	CA business income	10,000

Henry's NOL carryover from 2003 was \$6,000, restated as if he had been a California resident for all prior years and \$3,000, restated as if he had been a nonresident for all prior years.

Determination:

Step 1: Compute Henry's current year NOL by netting his total business income and losses for his period of residency and his California source business income and losses for the period of his nonresidency:

CA business losses, before May 1, 2004	\$ (2,000)
Total business losses, after May 1, 2004	(16,000)
Total	\$ (18,000)
CA NOL allowed percentage, 2004	X 100%
Current year NOL, 2004	\$ (18,000)

Step 2: Prorate Henry's NOL carryover amounts based upon periods of California residency and nonresidency during 2004.

<u>Period of Residency</u>		<u>Period of Nonresidency</u>	
NOL carryover, as if a CA resident for all prior years	\$ (6,000)	NOL carryover, as if a nonresident for all prior years	\$ (3,000)
<i>CA resident days ÷ total days</i> 245 ÷ 366	X .6694	<i>Nonresident days ÷ total days</i> 121 ÷ 366	X .3306
Prorated NOL carryover	<u>\$ (4,016)</u>	Prorated NOL carryover	<u>\$ (992)</u>

Step 3: Compute Henry's prior year NOL carryover:

NOL carryover from 2003, resident period	(4,016)
NOL carryover from 2003, nonresident period	(992)
Total NOL carryover from 2003	<u>\$ (5,008)</u>

Reviewed: March 2005

3830 ALTERNATIVE MINIMUM TAX

For tax years 1987 and after, alternative minimum tax is permitted under California Revenue and Taxation Code section 17062, which conforms to Internal Revenue Code section 55 – Internal Revenue Code section 59.

- **For taxable years beginning prior to 2002:**

For nonresidents and part-year residents, compute the tentative minimum tax as if the taxpayer were a resident for the entire year. Then multiply the tentative minimum tax by the ratio of alternative minimum California source adjusted gross income to total alternative minimum adjusted gross income.

- **For taxable years beginning on or after January 1, 2002:**

The **California alternative minimum tax** of a nonresident or part-year resident is the amount by which the California tentative minimum tax exceeds the prorated regular tax. The computation is:

CA alternative minimum tax = CA tentative minimum tax – Prorated regular tax

The **California tentative minimum tax** is the California alternative minimum taxable income multiplied by a rate. The rate is the amount of tax on total tentative minimum tax divided by the total alternative minimum taxable income. the computation is:

$$\text{California tentative minimum tax} = \text{California alternative minimum taxable income} \times \frac{\text{Total tentative minimum tax}}{\text{Total alternative minimum taxable income}}$$

The **California alternative minimum taxable income** is the combined total of:

- The alternative minimum taxable income derived from California sources for any part of the taxable year the taxpayer was a nonresident.
- The alternative minimum taxable income from all sources for any part of the taxable year the taxpayer was a resident.

For the period of nonresidency, include or allow any carryovers, deferred income, suspended losses, or suspended deductions only to the extent they were derived from California sources.

The **total alternative minimum taxable income** is the alternative minimum taxable income determined as if the nonresident or part-year resident were a California resident in both of the following:

- Current year.
- All prior years for any carryovers, deferred income, suspended losses, or suspended deductions.

Total tentative minimum tax is the tax on the total alternative minimum tax income.

The following example shows how the calculation works:

Example 1: Susan and her spouse moved to California and became residents on May 1, 2002. Combined wages for the year totaled \$170,000. Susan received \$100,000 after her move to California. On October 1, 2002, Susan exercised an incentive stock option valued at \$90,000, for which she paid \$10,000 (preference amount \$80,000). The total taxable income for the year was \$150,000, with \$20,000 in itemized deductions. Five thousand dollars (\$5,000) of the itemized deductions were real and personal property taxes, which are preference items. The prorated regular tax was \$6,000.

Determination:

Total alternative minimum taxable income

Real and personal property tax preference	5,000
Plus: Incentive stock option preference	+ 80,000
Plus: Total taxable income	+150,000
Total alternative minimum taxable income	<u>235,000</u>

Total tentative minimum tax

Total alternative minimum taxable income	235,000
Less: Exemption amount	<u>- 65,114</u>
	169,886
Alternative minimum tax rate	x .07
Total tentative minimum tax	<u>11,892</u>

California alternative minimum tax adjusted gross income

California (regular tax) adjusted gross income	100,000
Plus: Incentive stock option preference amount	+ 80,000
California alternative minimum tax adjusted gross income	<u>180,000</u>

Total alternative minimum tax adjusted gross income

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Total alternative minimum taxable income			235,000
Total itemized deductions	20,000		
Less: Real and personal property tax preference	<u>- 5,000</u>		
Total alternative minimum tax itemized deductions			<u>+ 15,000</u>
Total alternative minimum tax adjusted gross income			250,000
California alternative minimum taxable income			
Total alternative minimum tax itemized deductions	15,000		
Multiply by the ratio:			
<u>CA alternative minimum tax adjusted gross income</u>	<u>180,000</u>	=	<u>x .7200</u>
Total alternative minimum tax adjusted gross income	250,000		
Prorated alternative minimum tax itemized deductions			<u>- 10,800</u>
California alternative minimum taxable income			169,200
California alternative minimum tax			
California alternative minimum taxable income			169,200
Multiply by the ratio:			
<u>Total tentative minimum tax</u>	<u>(11,892)</u>	=	<u>x .0506</u>
Total alternative minimum taxable income	(235,000)		
California tentative minimum taxable income			<u>8,561</u>
Less: Prorated regular tax			<u>- 6,000</u>
California alternative minimum tax			2,561

Reviewed: January 2004

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3840 PASSIVE ACTIVITY LOSSES

We allow a passive activity loss deduction under California Revenue and Taxation Code section 17551, which conforms to Internal Revenue Code section 469. Effective January 1, 1987, individuals can only offset losses from passive activities with income from passive activities. Taxpayers can carry forward disallowed losses and credits can be carried forward to subsequent years and use them to offset income from passive activities for those years.

- **For taxable years beginning on or after January 1, 2002:**

Always a Nonresident

If a taxpayer has always been a nonresident of California, determine the allowed passive activity losses and suspended losses based only upon California source passive income and loss items to compute California taxable income. Nonresidents can carry forward only California source passive losses into the following year.

Example 1: Gary has always been a resident of Texas. Prior to 2002, he was not engaged in any passive activities. During 2002, Gary purchased rental properties in both California and Texas. In 2002, his California and non-California source passive income and losses included California rental income of \$2,000, California rental losses of \$30,000, and Texas rental income of \$4,000.

Determination: Based upon the netting of his passive income and losses and the allowance of up to \$25,000 for rental losses, determine Gary's passive losses allowed in 2002 and suspended to 2003 as follows:

Taxable year 2002:	Total taxable income	CA taxable income
CA rental income	\$ 2,000	\$ 2,000
CA rental losses	(30,000)	(30,000)
TX rental income	4,000	
Total	\$ (24,000)	\$(28,000)
Allowed rental losses	24,000	25,000
Suspended loss to 2003	\$ 0	\$ (3,000)

Example 2: Peggy has always been a resident of New York. Prior to 2002, she was not engaged in any passive activities. During 2002, Peggy became engaged in California and non-California passive activities. In 2002, her passive income and losses included California source partnership income of \$2,000, California source S corporation losses of \$8,000, and New York partnership income of \$3,000.

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Determination: Based upon the netting of her passive income and losses, determine Peggy's suspended losses to be carried forward to 2003 as follows:

Taxable year 2002:	Total taxable income	CA taxable income
CA partnership income	\$ 2,000	\$ 2,000
CA S-corporation loss	(8,000)	(8,000)
NY partnership income	3,000	
Suspended loss to 2003	<u>\$ (3,000)</u>	<u>\$(6,000)</u>

Change of Residency to California (Move-in)

For taxable years beginning in 2002, if a taxpayer had suspended passive losses and was a nonresident of California in prior years, the suspended passive losses need to be restated as if the taxpayer had been a California resident for all prior years.

Example 3: Assume the same facts as Example 2. On January 1, 2003, Peggy becomes a California resident. In 2003, her passive income and losses include California source partnership income of \$3,000, California source S corporation losses of \$1,000, and New York source partnership income of \$7,000.

Determination:

Step 1: Restate Peggy's 2002 suspended passive loss as if she had been a California resident for 2002.

2002 Restatement:	Total taxable income
CA partnership income	\$ 2,000
CA S corporation loss	(8,000)
NY partnership income	3,000
Suspended passive loss to 2003	<u>\$ (3,000)</u>

Step 2: Net Peggy's passive income and losses to determine the amount of passive income to include in total taxable income.

Taxable year 2003:	Total taxable income
CA partnership income	<u>\$ 3,000</u>

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CA S corporation loss	(1,000)
NY partnership income	7,000
Total	<u>\$ 9,000</u>
Suspended passive loss, 2002	(3,000)
Passive income, 2003	<u>\$ 6,000</u>

Change of Residency from California (Move-out)

For taxable years beginning in 2002, if a taxpayer has suspended passive losses and becomes a nonresident of California, the taxpayer's suspended passive losses need to be restated as if the taxpayer had been a nonresident of California for all prior years.

Example 4: Assume the same facts as Examples 2 and 3. On January 1, 2004, Peggy becomes a nonresident of California again. During 2004, her passive income and losses include California source partnership income of \$15,000, California source S corporation losses of \$7,000, and New York source partnership income of \$2,000.

Determination:

Step 1: Restate Peggy's suspended passive losses as if she had been a nonresident of California for all prior years by netting passive income and passive losses from California sources only.

2002 Restatement:	Total taxable income	CA taxable income
CA partnership income	\$ 2,000	\$ 2,000
CA S corporation loss	(8,000)	(8,000)
NY partnership income	3,000	
Suspended passive loss to 2003	<u>\$ (3,000)</u>	<u>\$ (6,000)</u>

2003 Restatement:	Total taxable income	CA taxable income
CA partnership income	\$ 3,000	\$ 3,000
CA S corporation loss	(1,000)	(1,000)
NY partnership income	7,000	
Total	\$ 9,000	\$ 2,000
Suspended loss from 2002	(3,000)	(6,000)
Income or suspended loss, 2003	<u>\$ 6,000</u>	<u>\$ (4,000)</u>

Step 2: Net Peggy's passive income and losses to determine the amount of passive income to include in total taxable income and California taxable income.

Taxable year 2004:	Total taxable income	CA taxable income
CA partnership income	\$15,000	\$ 15,000
CA S corporation loss	(7,000)	(7,000)
NY partnership income	2,000	
Total	\$10,000	\$ 8,000
Suspended loss from 2003	0	(4,000)
Passive income, 2004	<u>\$10,000</u>	<u>\$ 4,000</u>

PART-YEAR RESIDENT

If a taxpayer changed residency during a taxable year beginning on or after January 1, 2002, compute income and deductions using resident rules for the period of the year the taxpayer was a California resident and nonresident rules for the period of the year the taxpayer was a nonresident. Compute any suspended passive losses as if the taxpayer were a California resident for all prior years and as if the taxpayer were a nonresident for all prior years. Prorate both suspended passive loss amounts based upon the period of California residency and the period of nonresidency during the year.

Example 5: George became a nonresident of California on October 1, 2002. His passive activities did not include any rental properties. His total and California source passive income and losses for 2002 were as follows:

<u>Before October 1, 2002</u>		<u>After October 1, 2002</u>	
Total passive income	\$ 13,500	Total passive income	\$ 4,500
CA passive income	7,500	CA passive income	2,500
Total passive losses	(3,000)	Total passive losses	(1,000)
CA passive losses	(6,000)	CA passive losses	(2,000)

George's suspended passive loss from 2001 was \$7,000, restated as if he had been a California resident for all prior years and \$5,000, restated as if he had been a nonresident for all prior years.

Determination:

Step 1: Net George's total passive income and losses for the period of residency and his California source passive income and losses for the period of nonresidency.

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Total passive income, before October 1, 2002	\$13,500
Total passive losses, before October 1, 2002	(3,000)
CA passive income, after October 1, 2002	2,500
CA passive losses, after October 1, 2002	(2,000)
Passive income before suspended losses	<u>\$11,000</u>

Step 2: Prorate George's suspended passive loss amounts based upon periods of California residency and nonresidency during 2002.

Period of Residency

2001 suspended loss, as if a CA resident for all prior years	\$(7,000)
CA resident days ÷ total days (273 ÷ 365)	X .7479
Prorated 2001 suspended loss	<u>\$(5,235)</u>

Period of Nonresidency

2001 suspended loss, as if a nonresident for all prior years	\$(5,000)
Nonresident days ÷ total days (92 ÷ 365)	X .2521
Prorated 2001 suspended loss	<u>\$(1,260)</u>

Step 3: Compute George's passive income or suspended loss for taxable year 2002.

Taxable year 2002:

	CA taxable income
Passive income before suspended losses	<u>\$11,000</u>
Suspended passive loss, resident period	(5,235)
Passive loss, nonresident period	(1,260)
Passive income, 2002	<u>\$ 4,505</u>

Reviewed: January 2004

3900 OTHER STATE TAX CREDIT

California allows a credit against net tax for tax paid to another state on income that is taxed by both states. Taxpayers cannot apply the credit against city, local or foreign taxes paid.

Residents

For California residents to claim the credit:

- The tax must be paid to a state that does not allow California residents a credit against taxes imposed by that state. See California Schedule S for a listing of the applicable states.
- The income must have its source in the other state. California law and its associated case decisions are the authority for the determination of the source of income, or any matter affecting the computation regardless of any provision or interpretation of the law of the other state.
- The same income must be taxed by both states. Generally, income that is taxed by California and the other state will be the same amounts. However, the double taxed income amounts reported on California Schedule S, Part 1(b) and 1(c) may be different because of differences in California and the other state's tax laws, or because of basis differences.
- Substantiation must be provided showing that a tax return was filed with the other state.
- Substantiation must be provided that taxes were paid to the other state.

See California Revenue and Taxation Code section 18001 and California Code of Regulations section 18001-1.

Example 1: John filed a California resident return for 2000. He claimed the other state tax credit for taxes paid to New York attributable to wages he earned while working temporarily in New York. A copy of John's 2000 New York nonresident return was attached to the California return indicating he paid income tax to New York on the wage income.

Determination: Residents of California are allowed the other state tax credit for net income taxes paid to New York. John is allowed the other state tax credit because the source of the wage income was in New York and the same wage income was taxed by both California and New York.

Nonresidents

For nonresidents of California to claim a credit:

- The tax must be paid to a state that allows California residents a credit against taxes imposed by that state. See California Schedule S for a listing of the applicable states.
- The income must have its source in California. California law and its associated case decisions are the authority for the determination of the source of income, or any matter affecting the computation regardless of any provision or interpretation of the law of the other state.
- The same income must be taxed by both states. Generally, income that is taxed by California and the other state will be the same amounts. However, the double taxed income amounts reported on California Schedule S, Part 1(b) and 1(c) may be different because of differences in California and the other state's tax laws, or because of basis differences.
- Substantiation must be provided showing that a tax return was filed with the other state.
- Substantiation must be provided showing that taxes were paid to the other state.

See California Revenue and Taxation Code section 18002 and California Code of Regulations section 18001-2.

Example 2: Susan filed a California nonresident return for 2000 and reported she was an Arizona resident. She claimed the other state tax credit for taxes paid to Arizona attributable to wages she earned while working temporarily in California. A copy of Susan's 2000 Arizona resident return was attached to the California nonresident return indicating she paid income tax to Arizona on the wage income.

Determination: Residents of Arizona are allowed the other state tax credit for taxes paid to California. Susan is allowed the other state tax credit because the source of the wage income was in California and the same wage income was taxed by both California and Arizona.

Part-Year Residents:

For part-year California residents to claim the credit:

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- Follow the Resident rules for the period they were residents.
 - Follow the Nonresident rules for the period they were nonresidents.

Partners and S corporation Shareholders:

Members of partnerships and S Corporation shareholders are allowed to treat their pro rata share of tax paid to another state by the partnership or S Corporation as if it had been paid by the partner or shareholder.

See California Revenue and Taxation Code section 18006.

Reviewed: January 2004

4000 RESIDENCY AUDIT PLAN

RSTM 4100	Purpose
RSTM 4200	Discussion of the Audit Plan with the Taxpayer
RSTM 4300	The Audit Plan
RSTM 4400	Conclusion

Reviewed: January 2004

4100 PURPOSE

We follow the audit plan to promote the timely completion of the audit and to provide the taxpayer with an explanation of the audit procedures used during the course of a residency examination. The audit plan also serves to encourage a good working relationship between you and the taxpayer.

The key to conducting an effective and efficient audit is maintaining open lines of communication and establishing a partnership relationship between you and the taxpayer. This will result in a less burdensome, less costly, and less intrusive audit process. Maintaining open communication with the taxpayer is necessary and should not end with the initial discussion. For example, you may need to discuss the statute of limitations at a later date or expand the audit should circumstances require.

We use the audit plan as a tool to clarify to all parties the:

- Issues involved.
- Time frame to complete the audit.
- Extent of the examination.
- Procedures of records collection.
- Policies regarding penalties and protest.
- Responsibilities of the auditor and the taxpayer.

Reviewed: January 2004

4200 DISCUSSION OF THE AUDIT PLAN WITH THE TAXPAYER

Discuss the audit plan with the taxpayer over the phone or in person after your initial contact and prior to sending any information document requests.

Bring to the taxpayer's attention that the initial contact letter includes the *Frequently Asked Questions About Your Residency Audit* pamphlet and the name and telephone number of your supervisor and program manager. In all aspects of the audit, first encourage the taxpayer to discuss and resolve any issues with you. If the taxpayer feels supervisor participation will facilitate the examination, the names and numbers are available to them in the initial contact letter.

The *Residency Audit Plan* is a work aid and is not a formal written contract or agreement. You should clearly convey to the taxpayer that the audit plan discussion is a general outline of the possible audit steps. You can modify or omit these steps depending on the facts and circumstances of your case. You should present the audit plan in discussion form only and document the discussion.

Reviewed: January 2004

4300 THE AUDIT PLAN

When you initially begin the audit plan discussion, use this time to get to know more about the taxpayer. Learning about the taxpayer helps you plan the audit and ensures both parties expend minimal time and effort during the audit. The taxpayer can gain a stronger understanding of the residency audit process when you discuss the following subjects.

Issue:

Your preliminary research will determine the initial focus of the audit. To clarify the issues, be prepared to discuss this information. You can add or eliminate issues based upon your review of information provided during the audit. The discussion should include, but is not limited, to the following:

- Primary Issue
 - Residency
- Secondary Issue
 - Sourcing
 - Other State Tax Credit
 - Other income and expense issues
- Other Program Issues

You need to inform the taxpayer that other program areas, such as S Corporations, Partnerships, and other Pass-Through Entities are not part of the scope of your audit and as such, the taxpayer is still subject to further audit activity resulting from adjustments made to related entities.

Possibility of expanding the audit to subsequent years.

Time Frame:

Our common goal is to complete the audit in a timely manner. You can alter the time frame depending on the timely responses to your requests for information, and unforeseen circumstances. Things to consider in establishing the time frame are, the taxpayer's other commitments and time constraints and your workload. You and the taxpayer should agree to certain time frame criteria including:

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- Response Time
 - You and the taxpayer should establish agreed upon deadlines regarding response times. The normal response time to information document requests is 30 days from the date of delivery. You and the taxpayer can discuss extensions and revisions to response times based on the facts and circumstances.
- Meetings
 - You should hold conferences to discuss the status or the progress of the examination as needed.
- Waiver
 - You may request a waiver if you cannot resolve your audit before the expiration of the Statute of Limitations.

Extent of Examination:

You must consider all facts and circumstances surrounding the taxpayer's situation to determine residency status. Your examination will include information and documentation from states and countries where the taxpayer has relevant ties and physical presence.

You base your audit determination on all relevant documents provided or obtained during the course of the audit. No single piece of documentation is controlling.

You should discuss the following categories:

- Background
- Real Property
- Personal Property
- Business Profile
- Financial Profile
- Personal Profile
- Physical Presence

Procedures of Records Collection:

The extent of the information you gather will vary according to the individual facts and circumstances of each audit. Make every effort to request only relevant information necessary to make a proper audit determination. Conduct an interview or obtain a statement from the taxpayer to obtain background information. Evaluate the alternative sources of information by balancing the need with the associated burden of acquiring such information. Apply your experience and judgment to determine the degree of documentation required to complete the audit, on a case-by-case basis. Adhering to our policies and practices ensures the taxpayer that all documentation and information sent to us is protected and remains confidential.

Information Document Request(s):

- Prepare the Information Document Request (IDR) in writing with established response deadlines.
- Discuss and clarify the content and format of the IDR.
- Contact the taxpayer prior to delivering an IDR, to clarify, modify and expedite the request. This provides the opportunity to discuss alternative documentation.
- Request records deemed necessary for the audit from the taxpayer.
- Obtain information from third parties directly by requesting the taxpayer to sign an authorization to release information.
- There are circumstances when you, based on your discretion, may contact third parties directly, with prior notification to the taxpayer. Third party interviews with the use of signed affidavits may be necessary.

Demand To Furnish Information:

- For taxpayer - Failure to furnish information requested in writing may result in issuing a formal legal demand. Failure to comply with the formal demand may result in a 25% penalty.
- In addition, a continued pattern of failure to furnish information demanded may also result in subpoena action. You may issue a subpoena to any record holder.
- For third parties - Demand to Furnish Information, you may use if deemed appropriate. (The 25% penalty mentioned above does not apply to third parties.)

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PENALTIES AND PROTEST POLICIES:

Thorough discussion of penalties and protest may become important as the audit develops. You should consider introducing the following information:

- Penalties-- Depending on the facts and circumstances of the case, the department may apply various penalties to the tax liability.
- Protest-- In the event the taxpayer disagrees with the audit determination, provide the taxpayer with their protest rights.

Responsibilities of Parties:

You can complete the audit process in a professional and timely manner when you and the taxpayer work cooperatively together. You and the taxpayer should establish a list of responsibilities that include the following:

- *Taxpayer*
 - To provide information requested within the established deadlines agreed upon under *Time Frame*.
 - To inform you in writing of the circumstances and additional time needed to comply with your request, if the taxpayer cannot meet a deadline.
 - To provide all information concerning relevant states or countries so that you can make an accurate audit determination.
 - To provide copies of all requested information and documents.
 - To respond in writing to your determination letter. You should have an agreement of the facts presented. Also, this is the taxpayer's opportunity to clarify the facts and provide supporting documentation and proper authority for their position if they disagree.
- *You – the auditor*
 - To protect the taxpayer's privacy and ensure security of taxpayer information.
 - To respond in a timely manner.

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- To examine all facts concerning relevant states or countries.
 - To inform the taxpayer on the progress of the audit.
 - To hold a closing meeting or discussion with the taxpayer regarding your audit findings.
 - To provide a written summary of the audit determination.
 - To provide a written response to the taxpayer's reply to your determination, if necessary.
This response should include any facts still not agreed to.

Reviewed: January 2004

4400 CONCLUSION

Implementing our practices and procedures discussed in this plan reflects our commitment of working with taxpayers and conducting the audit using the most effective and efficient audit procedures. Establishing a relationship that focuses on communication can result in a timely, less burdensome, less costly, and less intrusive audit process.

Reviewed: January 2004